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How Peloton Built the Foundation for Enduring Success (A)

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Peloton has grown to become the $25 billion leader in the connected fitness category the company created in 2012. But founder John Foley encountered self-described "bone-crushing" challenges for years, before seeing his vision gain market acceptance. How did Peloton build the foundation for initial success and can it fulfill Foley's aspiration for it to be recognized as one of the great companies of his generation?

Introduction

In late 2011, John Foley had an idea for a new venture. His connected fitness concept would require skills in hardware design, software development, professional video production and physical retailing, none of which matched the founder's experience.[1] Nor did Foley neatly fit the entrepreneurial stereotype of a brash, young and passionate, if inexperienced, innovator. The then 40-year-old Harvard Business School graduate (2001) had a high-paying job as the president of Barnes & Noble's e-commerce business, and was living comfortably in New York City in a mortgaged condo with his wife and two children. But Foley began to feel he was just spinning wheels, running a money-losing business that was late to the game competing against Amazon in its core category. In the back of his mind, Foley was casting about for a new business to launch.

As with so many successful innovations, the inspiration for Peloton grew out of a frustrating personal experience. Both Foley and his wife, Jill, were avid fitness buffs who attended several studio fitness classes every week. In 2011 in New York, the indoor-cycling craze was in full bloom1. Soul Cycle had launched five years earlier and already had eight studios in operation. Another boutique fitness company, Flywheel joined the fray in 2010, introducing a new display unit that measured bicycle resistance along a gamification screen ranking riders' performance.[2]

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But as much as the Foleys enjoyed their fitness regimen, the demands of juggling child care and career responsibilities made it challenging to get to their neighborhood fitness studios, not to mention the increasing difficulty of securing prized reservations for top instructors, whose classes generally sold out within seconds of unlocking online reservations.

All of which got Foley thinking: While boutique fitness companies served a growing market need, they faced also a severe scalability problem. The best instructors could serve no more than a few dozen studio customers at a time, leaving a large, untapped (and often frustrated) addressable market. What if, Foley imagined, he could create a company where consumers could access great hardware (the best bikes) in the best location (their homes), inspired by the best instructors teaching a vast array of classes, joined by a virtually unlimited global community of fellow riders, all time-shifted to meet each customer's particular schedules, needs, and preferred playlists? This was Foley's vision for Peloton.

By May 2020, Peloton had attracted more than 2.6 million members into its loyal subscriber community[i] and rewarded its investors and employees with exceptional value creation. But this outcome was far from clear in 2011.

Ideation

The idea for what would become Peloton had come to Foley in a rush. He had mentally mapped out all the key elements of Peloton's business concept and its compelling consumer value proposition (CVP) before sharing his thinking with anyone.

The first person he told was Jill: Foley was fortunate to get instant reinforcement at home. As Foley later said, "She knew the category, she knew me, and was behind it very early."[3]

Next, Foley explained his concept to his mentor, John Pleasants, (then president of Disney's interactive media group) during a shared vacation on a Disney cruise while the two were riding stationary bikes in the onboard gym. Pleasants had never been to a spin class before, so Foley talked him through the kind of experience Pleasants could have on a better bike, motivated by an inspiring coach urging him on via an oversized tablet screen. Pleasants was intrigued and there and then agreed to become Peloton's first angel investor.[4]

Foley then turned his attention to recruiting a cofounding management team. He approached two ex-colleagues, Hisao Kushi and Tom Cortese, both of whom had worked with Foley at Barry Diller's IAC Corporation[5]. Kushi had been general counsel for CitySearch, Evite, and other IAC ventures and knew the ins and outs of setting up new companies. Kushi was intrigued with Foley's concept and agreed to advise Peloton part time, albeit while retaining

[i] Peloton, Company Overview, May 2020, p.4, from Peloton investor relations website, https://investor.onepeloton.com/static-files/701c7555-55e3-4f82-8b70-b58463ed44aa, accessed August 28, 2020. (Note: community-member total includes connected fitness subscribers, which on average have approximately two user profiles per exercise bike or treadmill: commercial user profiles and paid digital user profiles, excluding free trials.)

his full-time position at Liberty Media (before becoming Peloton's full-time chief legal officer in 2015).

Cortese, was a trusted ex-colleague and friend whom Foley described as a can-do, positive guy who "I would never want to start a company without."[6] Cortese was in the process of winding down an IAC venture that failed to gain traction, so the timing for Foley's recruiting pitch was propitious. Cortese went to Foley's house for what he just expected to be a friendly get-together. Shortly after dinner, however, Foley whipped out a computer and showed Cortese a screen emblazoned with one large word: PELOTON. When Cortese asked, "What's Peloton?" Foley responded, "It's a business we're going to build" and went on to explain his concept and vision. Cortese was interested, and signed on to become Peloton's cofounder and COO.[7]

Foley was on a roll. Four conversations after being struck with an innovative idea, he had gained the endorsement of a supportive spouse, a first-in investor, and the nucleus of an experienced management team. However, what followed for Peloton over the next eight years was what Foley later described as a "bone-crushing" experience[8].

Creating the Playbook

Foley faced two corollary challenges: to create his own playbook about every aspect of the new business while raising money for a venture with no track record and with considerable market acceptance and execution risk.

To get the ball rolling, Foley turned to family and friends to raise seed capital. With an intriguing concept and a relatively modest ask of $30,000, Foley was quickly able to raise $400,000 at a $2 million post-money valuation[9] from twelve investors-who could only dream at the time that the fledgling company's value would grow by one million percent over the next eight years.[10]

With quick but limited capital in hand, Foley set off to address a number of matters, starting with choosing the right design spec for the bicycle that would become an iconic symbol of Peloton's brand (see Exhibit 1).

Conventional wisdom suggests that to validate a new business concept, entrepreneurs should strive to quickly and inexpensively get a minimum viable product[11] to market, while using early adopter customer feedback to guide improvements over time. Accordingly, Foley's intent was to design Peloton's initial bike as a mashup, wiring up an existing bike with added electronics and a bracket to accommodate a customer's own tablet computer. This would allow Peloton to quickly launch a modestly priced product, while focusing the company's limited initial capital on software development for the computerized brains of the envisioned bike.

But after an extensive search, Foley found there wasn't a bike on the market that suited the company's needs. For starters, Foley "There were no sexy bikes in the market at all, let alone one that could track a rider's metrics and power."[12] Nor could the company find a monitor that was big enough, rugged enough, or sweat-proof enough for Peloton's intense use. Finally, Foley figured that partnering with a bike or tablet maker would put Peloton in a vulnerable position, saying "There's too much exposure--they could change something that would render our product irrelevant or antiquated."[13]

Foley then decided Peloton would develop its own integrated hardware and software by designing its bicycle, monitor, and operating system from scratch.

By early 2012, Peloton was also considering how to best recruit instructors for the spin classes that would one day be streamed to customers' home-based bikes. Foley's initial instinct was to partner with Soul Cycle or Flywheel to tap into the hundreds of classes these companies were already running in their growing network of fitness studios.

He proposed a joint venture: "You guys have instructors, you guys have studios, you guys make content. We're technologists, we're going to build a hardware and software platform. What about we come together?"[14] In other words, the fitness studios could earn incremental revenue from classes already running in their own capacity-constrained fitness studios, while Peloton could virtually deliver popular instructor-led classes to its home-based customers.

But as it turned out, neither company wanted in. Soul Cycle never expressed any interest, while Flywheel backed out of preliminary discussions after completing a new round of VC financing. At the time, both fitness companies were rapidly expanding their studio-based operations, and presumably saw little benefit in partnering with a pre-revenue company pursuing an untested business model. Peloton's founders once again found themselves on their own to build internal capabilities, which required capital.

To stretch their limited initial angel funding, Peloton's first four staffers took equity instead of salaries. In May 2012, those employees were Foley (who had by then left Barnes & Noble); Cortese; Graham Stanton, a former IAC colleague of Foley's who had invested $25,000 in the angel round; and Yony Feng, who was driving his worldly possessions in a U-Haul truck to a new tech job in San Francisco when he received a call from a friend about Peloton's vision. Intrigued, Feng contacted Foley for some hastily arranged conversations -- and wound up reversing course to New York to sign on as Peloton's fourth cofounder, becoming its CTO.

The management team's initial focus was on creating a suitable bike. They threw some of the company's precious angel capital at Eric Villency, whose design firm had helped SoulCycle create its fitness bike. Villency was tasked to come up with a 3D mockup of Peloton's hardware concept. Foley and his colleagues then started making reconnaissance trips to Taiwan trade shows to find a suitable manufacturing partner. The team learned a lot about the latest advances in electronics technology and manufacturing on those trips and ultimately inked an agreement with a Taiwan-based manufacturer to build Peloton's first prototype.[15]

Feng, meanwhile, remained in New York, working hard to prove Peloton could integrate a bike with a touchscreen tablet running an app that could upload real-time rider performance metrics while livestreaming video. He cobbled together a crude proof-of-concept prototype using a Schwinn stationary bike fitted with sensors connected to a microprocessor running his Android app, routed to a monitor jury-rigged to the bike's front end. "The tricky part was to get Android talking to the Schwinn," said Feng. "At that time, Android wasn't designed to talk to a bike in any way, shape, or form."[16]

Foley fondly recalled Peloton's first challenging two years of deep diving into product design, technology and manufacturing issues as "super fun." The tough thing though was in those years, "we were always about to run out of money. And when you have a vision and you have people, you need capital to build a business." Funding challenges are one of the biggest stressors facing entrepreneurs.[17]

The Money Hunt

The bulk of the fundraising burden fell on the CEO's shoulder. Now with a crude but working proof-of-concept bike under his belt, Foley set off with a heavy dose of hubris to pitch Peloton to VCs. "In the plans I pitched to investors, I said, 'I am going to take over the world' but for three years they said, 'Sure you are, but no thanks.'"[18]

After almost three years on the money hunt, Foley was turned down by 400 VCs before landing his first institutional investor. He recounted this demoralizing experience as follows:

> I thought when the venture capitalists heard my pitch, they would say, "Wow, this is true vision. This is true disruption." But what they were saying was "No, there's no research," there's no, what they call pattern recognition… It was frustrating because I saw it clear as day, and our early customers were saying, "Oh my gosh, this thing's changed my life!" They were going crazy for it, and still the investors weren't there. [19]

Foley's commitment to take no salary until Peloton secured adequate funding took a toll on his personal finances. "At one point, I told my wife… we're going to sell our 401(k) because we need the money. It doesn't sound very smart, but we … [were] desperate…I cleaned the bathrooms and vacuumed every day for three years in … [our] little place because we couldn't afford a cleaning … [service]."[20]

To keep Peloton afloat, Foley turned to two alternative sources of capital: angel investors and crowdfunding. He threw a wide net to attract new seed capital. "I would pitch three times a day for three years to get 100 angels to get the first [$3.5] million. But in order to get 100 angels at my success rate, I probably pitched 3,000 people."[21]

By early 2013, the first Peloton bike prototype, which Foley hoped to use for marketing materials and a Kickstarter campaign, arrived from Taiwan. But due to miscommunication with the manufacturer, the prototype was built 40% larger than the intended scale. Undaunted, Foley quickly sent revised specs to Taiwan and invited a 5"11" female friend to pose on the oversized bike so the proportions would look normal in photo shoots.

The next prototype arrived with the proper proportions but had serious design flaws. Jill, the first tester, quickly discovered the bike wobbled so badly she couldn't watch the on-screen spin-class videos; it was all a dizzying blur. The engineers tried tightening everything down, to no avail.

By this time, Peloton was hard pressed to shoot its promotional Kickstarter video with only a giant or wobbly bike to choose from. It went with the wobbly prototype and asked the model for the video shoots to be very gentle while riding to keep the bike from visibly shaking. In the finished Kickstarter campaign video[22], sharp-eyed viewers might have noticed that none of the hard-riding, thumping-music segments were shot on a Peloton bike. Said Foley, "You have to fake it till you make it!"[23]

The Kickstarter campaign was in part intended to market the product, but even more so to raise capital. But in that regard, it turned out to be a flop. Only about 200 early adopters ordered Peloton's $1,500 early bird bike during the Kickstarter campaign (which earned $300,000) half of whom were already angel investors in the company. "It was incredibly disappointing," said Foley. "We realized that this wasn't going to be one of those things that explodes and all the VCs would wire money tomorrow."[24]

Adding the Missing Pieces

With an urgent need to start selling bikes, Foley had four priorities on his to-do list: fix the bike's design flaws, recruit instructors, start producing spin-class videos and launch retail channels. The first task went relatively smoothly, and Peloton soon had a handful of fully functional, beautiful bikes to work with.

Recruiting instructors also proved surprisingly easy. Peloton started posting Facebook ads, presumptuously seeking "the 10 best instructors in the world." Not long afterward, Jenn Sherman, an experienced spin class leader, who exuded a fun-loving, charismatic, self-assured personality, urged Foley to "look no further; your search is over!"[25] After signing on as Peloton's first instructor, Sherman was joined by Marion Roaman, a former boutique fitness business owner, to help recruit and train additional spin-class leaders willing to believe in Foley's vision, even though the company still had no studio, stores, customers, or revenue. Still, an unexpectedly large group of instructors enthusiastically responded.

Building video production capabilities proved to be a greater challenge. None of Peloton's cofounders nor any of the company's 20 employees at the time knew anything about videography, equipment or production studio setup. So Foley and his team took a crash course through Google searches, Wikipedia, and lots of topically relevant books. Peloton's office happened to be near a reputable video equipment store, whose salespeople helped Peloton's novices choose the right equipment to launch a basic video production site.

The company's first de-facto studio was set up behind a curtain in its small office. "[We crammed in] four stationery bikes and … [mounted] a static camera [and rented studio lights] against the wall," Foley said.[26] Roaman added, "I would [tape sessions] and run auditions out of there, and these guys were working at their desks while girls were coming in wearing sports bras and the music was blaring." To this day, Cortese says he finds it difficult to work in an office without music blasting somewhere.[27]

By fall, 2013, Peloton had its web store up and running to take orders. The initial thought was to deploy a razor and blades strategy,"[28] pricing Peloton's bikes at cost ($1,200), with the hope of stimulating high demand for high-margin streaming video subscriptions. But early sales proved disappointing.

Foley hypothesized that Peloton's target customers may have perceived the low price as signaling low quality, undermining the company's bold claims of superior product performance.[29] So Peloton increased the price of its bikes to $2,000, without changing its monthly $39 subscription fee. While it was difficult to attribute a precise cause and effect after the price change, Peloton did find that bike sales ticked up a bit after the price hike.

Nonetheless, despite Peloton's superior product design, a growing library of streaming classes, a well-designed web store and targeted social media advertising, sales remained well below expectations. At that point, Foley realized, "We're back to the drawing board. We're going to have to market this thing the old fashioned way and get the product in front of consumers."[30]

One of the company's new staffers suggested Peloton test the waters of physical retailing by launching a pop-up store in the Mall at Short Hills, a luxury retail complex in an upscale New Jersey commuting suburb. The company signed a short-term lease on a beautifully furnished but recently shuttered leather-goods store and poached two young salesmen from the mall's Abercrombie & Fitch shop. All in, the pop-up store cost Peloton just $10,000 to launch and was open for business in November 2013.

Foley figured he could recover store operating costs by selling just one bike per day, but that return was far from assured. As Foley fretted at the time, "Who's going to …walk by a …mall [store] they've never heard of, come in and check out a [$2,000] bike, get out a …credit card and say 'I want one!' -- once a day, every day? We only had ten classes filmed at the time in a cheesy, curtained-off back office, and none of them live… [so we] were still selling a dream."[31]

But very soon, Peloton found it was selling five bikes a day. The company discovered that selling Peloton's CVP required an in-person, customer experience. According to Foley:

> You and your wife would walk … [into our popup shop], and I'd profile you and … say, okay she's probably SoulCycle, he's probably an outdoor cyclist…; there's some gender bias in fitness. One of you would get on the bike within two minutes… and I'd be adjusting the seat and minimizing the friction … [to get you] on the pedals and …hand over the headphones... And I'd know what class to start you with and what instructor you might like and what instructor she might like. This was all a fun game for me to try and get the hook in your mouth… as quickly as possible. I'd get you pedaling so the endorphins … [kicked in set the headphones on] loud music, and you would look over at your wife, and scream 'HONEY, THIS IS AMAZING!' [Customers] were [actually] screaming in the mall, because I'd

> make the music […so] loud. And generally if I could get somebody on a bike, honest to God, …[it] got to a point where there was 50/50 chance you were going to buy the bike, even though you just heard of it, because it is something that once you experience it and get on it and see it, it clicks that you want it![32]

Peloton wound up renewing its lease at the Short Hills Mall and opened four more mall-based shops, with equal success. But Peloton wasn't *delivering* five bikes a day from its each of its retail stores, nor would it for quite some time.

Given the company's uncertain sales outlook, neither Peloton nor its sole Taiwan-based supplier were willing (or able) to invest in adding production capacity or unsold inventory. As a result, Peloton faced a three to four month lead time to fulfill new orders. While it was a good problem to have, Foley sheepishly acknowledged later that the company mishandled the situation by overpromising and under-delivering, telling early customers that delivery would take no more than 30 days.[33]

Predictably, frustrated customers began flooding Peloton's website, phone lines and social media with complaints, sending the company the valuable message that most customers would graciously accept delivery delays, provided the company communicated frequently and honestly about realistic expectations.

The first bikes were finally sent to customers' homes in January 2014, only to have a new set of problems surface: Peloton initially relied on third-party companies to deliver and install its products…and it wasn't going smoothly. The deliveries required interacting with customers to complete the final bike setup, adjust the seat and handlebar to comfortably fit the customer, connect the bike to the owner's home Wi-Fi, and walk through basic operating instructions. As Foley described Peloton's initial customer experience, "Often, third-party fulfillment partners didn't have the human resources to meet the level of Peloton-caliber people."[34]

Peloton solved this problem by tasking key executives to take a crash course on logistics best practices to guide the implementation of new partnerships, operating procedures, and delivery-route optimization technologies. In recalling how Peloton improved its white glove delivery process, Foley said, "I don't know how people did this before the Internet…It's basic entrepreneurship, which is studying what other people are doing. In a cool way, you have second-mover advantage and you can do things better if you pay attention."[35] Peloton eventually set up an internal logistics division in 2018 to operate its own fleet of trucks and delivery personnel.[36]

VC FUNDING

By early 2014, Peloton had achieved rapidly growing sales, well on the way to $10 million in annual revenue, and had nurtured a growing community of customer advocates with an active presence on social media. However, heading into its third year of operation—and despite overcoming numerous design, pricing, and delivery hurdles—Peloton continued to struggle to raise capital. Said Foley, "I'd go out to VCs in Silicon Valley, but … [they] didn't see what was happening in New York City with the boutique fitness movement. They would say, there's two types of biking out here John, mountain biking and road biking."[37]

Foley revisited several VCs he had pitched a year earlier who had told him they wanted to wait till Peloton could demonstrate bike sales. But when he went back to update them on Peloton's progress, "a lot of … [them] would say "OK, you're selling bikes. But this is a subscription digital content business model. [Customers] might buy a bike but they might churn after a year or two. Come back then, after you have more cohort data."[38] But the demoralizing reality was that Peloton couldn't get two more years down the road if it didn't raise more money.

Finally, after almost three years of intensive fundraising, and rejections from 400 VCs, Peloton secured its first institutional funding in April 2014 from an unlikely source: Tiger Global Management (TGM), a New York-based hedge fund and private equity firm that traditionally dealt with large institutions, public corporations and later-stage startups, which led a $10.5 million B round in Peloton.[39]

TGM's investment freed Foley and his management team to devote their full attention to scaling Peloton's business, starting by opening a combined state-of-the-art boutique fitness and video production studio in the trendy Chelsea neighborhood of New York (see Exhibit 2), just one month after closing its B round.

Epilogue

By any measure, John Foley's vision, passion and dogged determination laid the groundwork for Peloton's remarkable success over the ensuing six years.[40] VCs piled in on subsequent funding rounds, pouring nearly $1 billion into the company in six subsequent funding rounds (see Exhibit 3). The company IPO'd in September 2019, raising another $1.2 billion.

At the end of FY 2020, Peloton had revenues in excess of $1.8 billion, earned $376 million in operating cash flow, served more than one million subscribers, sold bikes and treadmills in more than 100 stores in four countries, and delivered 175 million fitness classes through its global virtual network[41] (see Exhibit 4).

And yet, John Foley thinks the best is yet to come. Reflecting on Peloton's success, Foley said, "I honestly believe we're just getting started; we have massive global ambitions, and I think if we do our job well, Peloton will be one of the special companies of our generation."

The same can't be said about Soul Cycle and Flywheel, the boutique fitness companies who rejected Foley's proposed partnering relationship when Peloton was just getting started.

In August, 2019, Soul Cycle belatedly recognized the business potential of the connected fitness category, announcing it would begin selling its own version of an in-home, streaming video exercise bike by the Christmas shopping season. But Soul Cycle couldn't meet its launch schedule. It wasn't until May 2020 that its first bikes shipped – missing its scheduled release by six months -- – and even then in only three metropolitan areas By November, 2019, Soul Cycle's parent company's board of directors forced the resignation of long-serving CEO Stephanie Whelan. Whelan's dismissal followed the departures of the company's COO and Director of Business Development earlier that year.[42]

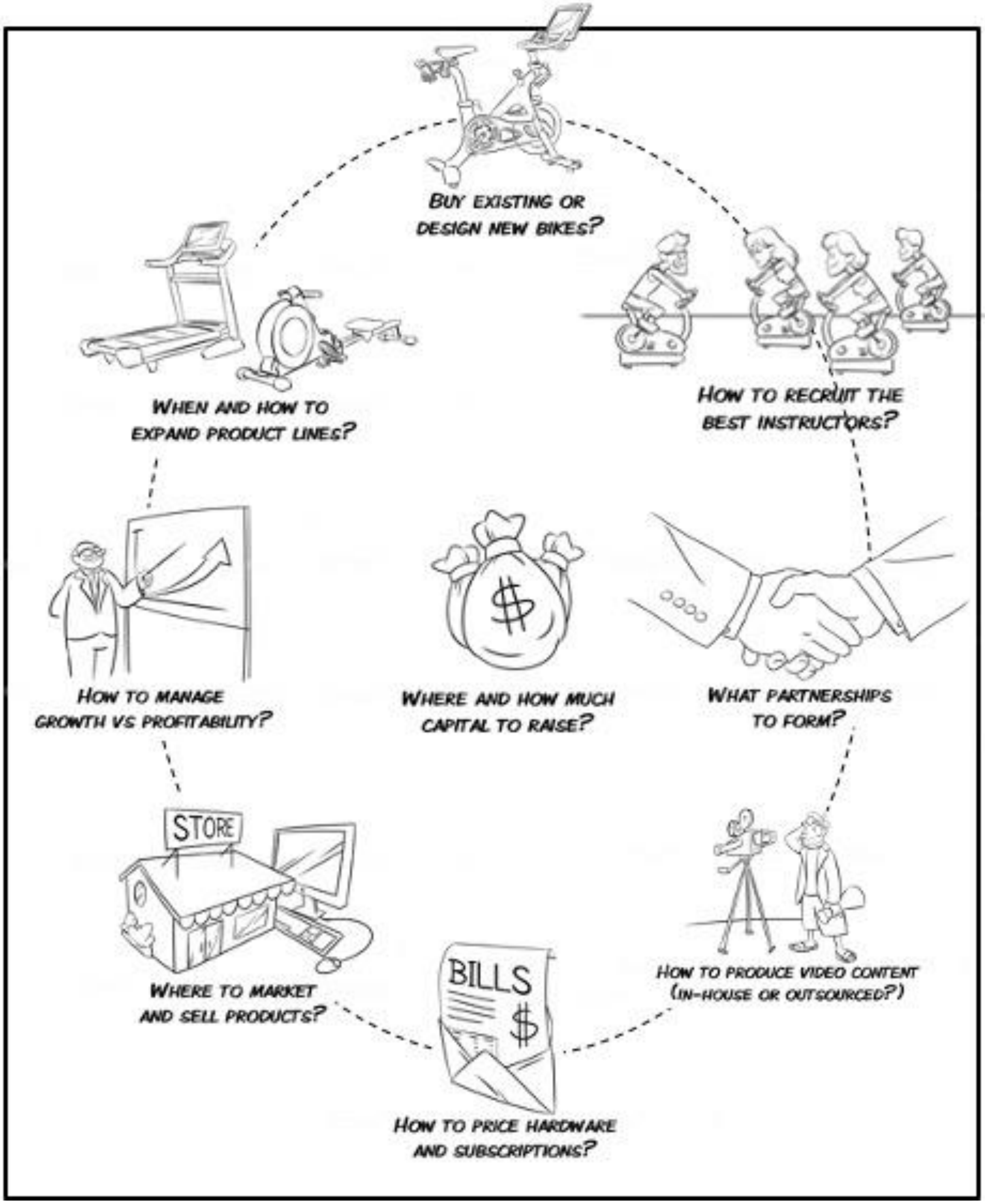
According to an analysis of credit and debit card transaction data, Soul Cycle's revenue plunged by almost 30% in the four weeks between mid-December 2019 and mid-January 2020, usually a strong holiday sale period for the firm.[43] In the spring of 2020, the COVID-19 pandemic-related closure of many of the company's boutique fitness outlets throughout the US, Canada and the UK put Soul Cycle under even more financial pressure. The company instituted a 25% pay cut for many employees in April 2020, then one month later laid off upward of 10% of its staff, with no severance.[44]

Flywheel launched its version of an at-home streaming video exercise bike in 2017 but was sued by Peloton for patent infringement shortly thereafter. Peloton won its case in early 2020, forcing Flywheel to discontinue offering its connected fitness bikes and online video classes by the end of March, 2020. The COVID-19 pandemic further ravaged Flywheel's business, leading the company to shut down 25% of its fitness studios. The company's lenders seized control of Flywheel in April 2020 and immediately began looking to sell what was left of Flywheel's dwindling fitness-studio network.[45]

Exhibits

Exhibit 1

Key Questions That Guided Peloton's Early Development



Source: Author rendering

Exhibit 2

Peloton's Video Production Studio

Source: Logan Sykes, "The Fanciest Spin Studio in NYC," *Town & Country,* March 10, 2015, https://www.townandcountrymag.com/leisure/sporting/news/a2833/peloton-the-fanciest-spin-studio-in-nyc/

Exhibit 3
Peloton's Funding Rounds

Date	Type	Lead Investors	Amount ($, millions)
October, 2011	Ideation	None; John Foley self-funded	$0
February, 2012	Seed	Angel investors	$0.4
December, 2012	Series A	Angel investors	$3.5
July, 2013	Crowdfunding	Kickstarter	$0.3
April, 2014	Series B	Tiger Global Management	$10.5
April 2015	Series C	Tiger Global Management	$30
December, 2015	Series D	L Catterton	$75
May, 2017	Series E	Fidelity Investments	$325
August, 2018	Series F	TCV	$550
September, 2019	IPO	Underwriters: JP Morgan, Goldman Sachs	$1,160

Source: Alex Wilhelm, "As Peloton Preps for an IPO, a Look Back at Its Funding History," *Crunchbase, News*, February 12, 2019s, https://news.crunchbase.com/news/as-peloton-preps-for-an-ipo-a-look-back-at-its-funding-history/

Exhibit 4
Peloton FY2020 Business Performance

Revenue $1,826 M	2020 YOY Revenue Growth Rate 100%
Operating Income ($81) M	Subscription Gross Margin 56.8%
Operating Cash Flow $376 M	Hardware Gross Margin 45.3%
Subscribers 1.1 M	Stores 103
Annual Retention Rate 92%	Market Cap (9/10/2020) $25 B

Source: Peloton Q4 2020 Shareholder Letter, https://investor.onepeloton.com/static-files/0160c736-f0d2-400a-8a20-6f6fc3f85659

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