Asheville Capital Portfolio Management Decision – Exiting Naked Wines (9.2.2022)

Decision: Exited Naked Wines at GBP 1.20.

Basis for decision: My thesis for Naked Wines has been damaged such that the range of expected outcomes is wider than originally anticipated. Naked could certainly still execute their vision, and my previous expectations could still be met. However, it seems increasingly likely that I was wrong in my assessment of their ability to cost-effectively grow at rates of return that meet the Asheville Capital standard for focus list inclusion.

Analysis: The crucial insight is this – ***While Naked has a unique, differentiated, and sustainably advantaged business model, its advantage is difficult to articulate to their target audience at-scale.***

On the positive side, multiple calls and channel checks have confirmed that Naked does, in fact, have an advantaged business model that cuts out layers of expenses within the heavily intermediated wine supply chain. This results in better wine at a better price and more money for winemakers at a lower total cost to the consumer. Naked's business model creates attractive incentives for both winemaker and wine customer.

On the negative side, ***it is incredibly difficult to articulate this value proposition to the general wine consumer***, which is Naked's target audience. The key message is harder to articulate than it is for other DTC brands. Take Temple & Webster for example; the key message is "buy furniture online". With those three words, the value proposition for TPW is clearly articulated. Sure, there are secondary messages like infinite assortment, doorstep delivery, attractive prices, best-in-class customer experience. But in Australia, where online penetration is low, little else needs to be said to win customers over… Temple & Webster is the destination for buying furniture online.

Alternately, Naked Wines' investment thesis hinges on its ability to win over a substantial proportion of wine consumers in the United States. The message to "buy wine online" does not have the same effect on the American wine consumer as "buy furniture online" might have for the average Australian. Further, ***Naked Wines' advantage does not merely stem from being the destination for buying wine online, but rather, from their ability to provide better wine at a lower total cost***. That is much more difficult to clearly articulate to the masses effectively, especially when there are acceptable substitutes such as in-store wine purchases and dozens of online wine clubs.

Naked Wines' business model is superior to its competition. It is just difficult to convey that superiority to its target audience.

This qualitative insight carries massive quantitative implications. Take for example, the difference in acquisition costs between Temple & Webster and Naked Wines. TPW paid $46 (AUD 68) this past year in marketing expenses per customer. Naked Wines paid $201 (GBP 175) for each customer. Note that this is not an apples-to-apples comparison. Temple & Webster is not a subscription business and therefore gets to spread its acquisition expenses across a large customer base that it costs very little to reacquire annually. Naked's acquisition expenses can be broken down with a level of granularity that is not possible to do for Temple. But the general point that I am driving at remains, there is a wide chasm in acquisition costs based on the difference in qualitative value propositions that I have described above.

Despite similar contribution profit margins (30% for TPW and 27% for Naked Wines), Temple is able to generate a 2.5x return on investment within twelve months, while it takes Naked Wines 5 years to generate the same 2.5x return.

The question that I now must answer is why I did not appreciate this chasm in the first place. In a sense, I did. Naked has never accounted for more than 7% of total assets while Temple has accounted for as much as 22% of total assets after a temporary period of price appreciation. Additionally, if you chose to spread the acquisition costs for Naked Wines over its entire customer base, the total acquisition costs and return on investment looks very similar to Temple's. This is what I saw when initiating a position in Naked Wines…. That underneath the 2.5x 5-year ROI, there was a very profitable group of repeat customers that were subsidizing larger and larger proportions of total acquisition expenses.

This is still true. Naked Wines does have a profitable group of repeat customers for which Naked Wines has already broken even on and is using the cash flows from these customers to grow its net-new customers with. That is what I saw that made Naked Wines look a lot more attractive than the initial unit economics might suggest. Yet, there remains the problem of churn. Because Naked is a subscription business, it loses between 15-20% of its customers every year and must spend to replenish those lost customers before it can add net-new. This acts as a humongous drag on its ability to grow. The larger Naked gets, the more customers must be replenished annually before it can add net new. This factor in addition to rapidly rising acquisition costs acts as a dual headwind by which it is not necessarily good news when Naked goes through periods of rapid growth like it has in the past two years. For pure marketplace businesses, like Temple & Webster, this is less of a problem because customers repeat purchase when they are ready rather than by making monthly contributions to a slush fund with the DTC subscription model.

The presence of these dual headwinds is making it challenging for Naked Wines to grow and has become clearly evident to me following the recent FY'22 earnings report in which Naked announced that they will likely not grow revenues or customers at all in FY'23, and that they hope to double customers by FY'25, which would mark a five-year period ('21 inclusive) in which customers grew by 2x for a CAGR of 15%. It would be unreasonable to expect growth rate to increase beyond those five years, but rather to decelerate because of a larger denominator at that point coupled with the likely further increase in acquisition costs.

Our investment thesis is not simply based on revenue growth rate, but rather the increase in total intrinsic value… for which revenue is a crucial, but not all-important metric. The other metric that matters is operational leverage that can be gained on the business. It is fine if Naked only doubles their sales over a five-year period if the growth to intrinsic value grows as well, via cash flow generation.

This is where I have been most-disappointed with Naked in the last year. In the last twelve months cash from operations has swung from a positive $34 million to a negative $43 million, a $77 million dollar swing. This has primarily been due to a reinvestment in depleted inventory levels following periods of high demand and an ongoing supply chain crisis. Yet this investment has caused overstock and forced the company to reach out for a line of credit in the event that they burn through their remaining cash reserves, which currently sit at $39 million.

When I initiated a position in Naked Wines, I had a reasonable degree of confidence that I was buying an already free cash flow positive business, with delayed, yet profitable unit economics and an ability to grow to multiples of its existing size in both the mid and long-term. The long-term thesis is possibly still in place but my expectations for absolute value have been pushed out to well over the next decade to generate a return that I figured was accomplishable within a ten year period.

Despite the contraction in equity value, a conservative estimate of expected return for Naked has not increased because the fundamentals have deteriorated to the point that I can no longer estimate what a range of outcomes might be with a reasonable degree of accuracy. Suffice to say that the floor for expected returns is much lower than originally anticipated. I still like Nick Devlin (CEO) and believe that Daryll Rawlings (New Chairman) brings a wealth of experience in running a successful DTC business. I hold them both in high regard.

In the meantime, other positions represents a more attractive proposition more attractive unit economics, a tighter range on future expected outcomes, and deeper discounts to those expected outcomes. – *Jake (9.2.2022)*