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Farfetch IPO:

How **far** can it go? How much can it **fetch**?

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Abstract:

Title: Farfetch IPO: How far can it go? How much can it fetch?

The following case describes the dilemma faced by Carmo, an Investment Advisor, a day ahead of Farfetch's Initial Public Offering. It covers the company's journey since its foundation in 2007 to its IPO in late September 2018. Over the course of ten years, the company has demonstrated a remarkable growth path as a result of the deep relationships it has built and nurtured, but it is still thriving to become profitable. As Farfetch prepares to go public, Carmo is faced with issues such as the chosen listing location, the company's dual class structure and the offering valuation.

Keywords: Capital-Light Business Model, Cash Conversion Cycle, Initial Public Offering, Dual Class Structure

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How **far** can it go? How much can it **fetch**?

It is the 20th of September 2018 and Carmo, a Senior Investment Advisor at ABC Partners, is comfortably sitting on her Uber on the way back to the office. After having met her clients to discuss Farfetch's Initial Public Offering (IPO), which is about to happen, her mind is being invaded by numerous concerns about the company.

Farfetch is a technology platform for the luxury fashion industry founded by José Neves, a Portuguese entrepreneur. Through the platform, the company operates the Farfetch Marketplace, which connects luxury fashion customers with luxury retailers and brands, and provides e-commerce management services and in-store technological solutions to famous luxury brands and designers, through Farfetch Black & White Solutions and Farfetch Store of the Future, respectively. The company is also the owner of Browns Boutiques since 2015.

Farfetch is about to go public and Carmo is considering investing on behalf of her clients as soon as the company starts trading on the public equity markets, but she is wondering whether it is a good investment opportunity. Despite high growth, the company hasn't seen green yet and Carmo is unsure about the feasibility of the company's business model and when or whether it will become profitable. Carmo is also concerned about the dual class structure the company aims to keep when going public and thinks that the valuation might be a little *far-fetched*.

A Unicorn is born

Originally from Guimarães, José Neves studied Economics at University of Porto and by his 20th birthday he had already founded Grey Matter[1], his first company. At the age of 22, inspired

[1] Grey Matter was a software house that created software to the retail sector

by his grandfather, he launched his second company, a shoe brand called Swear, based in London. In 2001, Mr. Neves launched the B Store, a brand that was granted a British Fashion Award in 2006. These companies depicted his two biggest passions: programming and fashion.

Mr. Neves was first introduced to programming when he was 8 and his parents gave him a ZX Spectrum for Christmas. (Un)Fortunately for him, the computer came with no video games, and along with it there was only one manual, which introduced him to programming. Fashion came later. Coming from the North of Portugal and from a family with tradition in shoemaking, fashion had always been part of his life but only when Grey Matter started to create software for retail clients, did Mr. Neves find his passion for fashion. Over the years, he performed a lot of different roles in the industry of fashion, from shoe designer to a boutique owner.

When Mr. Neves first thought of Farfetch, companies like Amazon were rocking and he knew that the Internet would inevitably transform the luxury fashion industry. He also knew that the industry needed an e-commerce platform and the already existing ones were not designed to respond to their needs. By 2007, Mr. Neves had already been living in London for several years and, therefore, the city seemed to be the obvious choice to establish Farfetch later that year.

However, setting Farfetch wasn't an easy job. Most luxury brands are family-owned companies to whom the business is all about the brand reputation, luxury heritage and the personalized customer experience. Would it be possible to keep all these through an e-commerce platform? When Mr. Neves started to meet with some of the most famous French and Italian families in the industry, the pre-conceived idea among them was that Farfetch would disrupt their businesses. At the time, his biggest challenge was to prove them otherwise. Farfetch "was created for the love for fashion" and would help them thrive.

Being based in the city of London was vital for the company to attract and retain talent while enjoying the perks of being under the spotlight of one of Europe's most prominent cities. In October 2008, Farfetch was officially launched, initially allowing customers from five countries to purchase products from twenty-five different boutiques. Between 2008 and 2018, Farfetch has nurtured and built deep relationships with prestigious brands and designers and signed partnerships with names such as Chanel[2], Gucci and Burberry.

[2] As of 2018, even though Chanel does not sell on the *Marketplace*, it is a client of *Farfetch Store of the Future*, having signed a partnership to enhance Chanel's boutique experience

Handshaker

Since its foundation and until 2010, Farfetch relied solely on Mr. Neves's own capital and only from 2010 onwards, did the company welcome private investors. Between 2010 and 2017, Farfetch made seven investment rounds, raising more than $700 million (**Exhibit 1**). Most of these rounds meant a whole more to the company than just raising capital from private investors, they were also strategic moves or the signing of valuable partnerships for the company.

In 2013, Farfetch established an important strategic partnership with Condé Nast[3] to fuel the company's international expansion. In May 2016, when Farfetch welcomed investors Temasek Holdings, IDG Capital and Eurazeo, Mr. Neves described it as a "strategic move". He was confident that Temasek and IDG Partners relationships and deep knowledge of the Asian markets would boost the company's growth in Asia.

Finally, in June 2017 JD.com[4] bought a stake in Farfetch, becoming Farfetch's largest shareholder and bringing Richard Liu, JD.com founder and CEO, to join the board of directors. The companies announced a strategic partnership that combines Farfetch's brand and curation with the giant's scale and influence in the Chinese market, the fastest growing market in luxury goods: the Boston Consulting Group estimates that 40% of the luxury goods market will be made by the Chinese by 2024, as can be seen in **Exhibit 2**.

Company Overview

Farfetch is mostly know for the Farfetch Marketplace, which is the source of over 90% of the company's total revenue, but the marketplace is only the tip of the iceberg, as can be seen in **Exhibit 3**. Farfetch has developed other platform applications such as Farfetch Black & White Solutions, the Store of the Future and the Seller Tools, and it also provides services like content creation, inventory management and fulfillment, and stores and manages the platform data.

Farfetch Marketplace

Farfetch operates an online marketplace for luxury goods, offering global online access to a broad[5] selection of luxury fashion. The Farfetch Marketplace, which includes Farfetch.com and the IOS and Android apps, connects 989 luxury sellers from 45 countries, of which 614 are retailers (of whom 98% have exclusive relationships with Farfetch) and 375 are brands, and

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[3] Condé Nast is an American mass media company owner of Vogue, Teen Vogue, GQ, and Vanity Fair
[4] JD.com is the second largest Chinese e-commerce company, a major competitor of Alibaba
[5] On the second quarter of 2018, the Farfetch Marketplace had 5.7 million stock units available with an aggregate value of $2.4 billion (**Exhibit 4**)

more than 2.3 million customers from 190 countries worldwide. **Exhibit 5** illustrates how the marketplace works.

The marketplace offers a strong value proposition for brands. As can be seen in **Exhibit 6**, brands benefit from better margins in the Farfetch channel than in the wholesale channel and, at the same time, from Farfetch's strong distribution capabilities that include delivery and return services, and an advanced technology infrastructure, providing marketing, customer service and payment solutions.

As of June 2018, the Farfetch Marketplace had 1.1 million Active Customers, up from 0.9 million as of December 2017, and, with a reported average age of 36 years old, most Marketplace customers are Millennials. Farfetch has been successful, not only in acquiring new customers, but also in retaining the existing ones. To do so, the company incurs in Consumer Acquisition Costs (CAC) which have shown to have a short payback period. **Exhibit 7** shows the Lifetime Value of a Consumer (LTV)[6] to CAC ratios for three different cohorts and the results are promising. After six months, the LTV/CAC ratios are already above one, which suggests that the company's high-investment strategy that generates negative short-term results may payoff in the future.

Farfetch Black & White Solutions

Launched in 2015, Farfetch Black & White Solutions is an independent business unit that provides e-commerce management services. Knowing that some luxury brands and retailers are not willing to give up on their authenticity and independence as far as their e-commerce presence is concerned, Farfetch decided to start selling tailored white-label versions of the platform to luxury brands and retailers in order to help them operate some or all aspects of their e-commerce presence

Through Farfetch Black & White Solutions, brands retain control over the design and daily operation of their own e-business and, at the same time, benefit from the same capabilities and scale as the Farfetch Marketplace, including international payments and logistics, customer service and omnichannel capabilities such as linking in-store inventory to the website in real time and delivery services like click-and-collect and in-store returns.

[6] Life Time Value of a Consumer is the expected benefit generated by the relationship with a customer from the moment the costumer is acquired

In August 2017, Certona announced a strategic partnership with Farfetch Black & White Solutions to provide its omnichannel personalization capabilities and patented artificial intelligence (AI) software. Already in 2018, Farfetch acquired CuriosityChina[7] to strengthen Farfetch Black & White Solutions digital marketing capabilities and allow its luxury partners to enter the Chinese market.

Farfetch Store of the Future

2017 witnessed a period of great turbulence in the retail business. The US alone saw 7,000 retail stores closing and well-known retailers such as Sears, Macy's and Toys R Us facing severe financial troubles. Although retail seemed fragile at the time and Farfetch's core business focused on the online, Mr. Neves was aware that retail still represented a large majority of luxury sales and, despite the growth of the online, that wasn't about to change in the years to follow. Hence, in that same year, Farfetch launched the Store of the Future, to sell in-store technological solutions to luxury brands aiming to provide a one-of-a-kind in-store shopping experience to their customers.

Farfetch Store of the Future is a bespoke solution that gives brands and retailers the flexibility to adopt the features that best suit them and their business model needs. Integration of the offline and online activity of a customer through a universal ID, RFID[8] and Smart Mirror[9] technologies, innovative payment options and instant in-store wish lists are some of the capabilities that Farfetch Store of the Future provides their partners. The Store of the Future was piloted in Thom Browne's[10] London and New York stores in early 2018, and a few months later in Browns East boutique.

Seller Tools

Farfetch developed powerful management tools that enable the marketplace luxury sellers to drive efficiencies. STORM provides luxury sellers with data and inventory management, consumer profiling and omnichannel fulfillment while FFLINK allows brands to integrate the Farfetch's platform with their own systems or third-party e-commerce solutions.

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[7] *CuriosityChina* is a Chinese digital marketing agency that specializes in leveraging social media, namely WeChat, to target and reach customers

[8] RFID (Radio-frequency Identification) technology tracks the location and movement of items in-store, monitors consumer browsing behavior and stores the data on the customer digital account

[9] Smart Mirror technology enables customers to view their personal wish list, summon products in different sizes and colors without leaving the fitting room or even to have access to data from previous purchases

[10] Thom Browne is a famous American fashion designer

Browns Boutiques

Moreover, in May 2015, Farfetch became a boutique owner itself when it acquired Browns, an iconic British fashion boutique founded in the 1970s. Browns is famous for having fostered the career of designers like Alexander McQueen, John Galliano and Christopher Kane. The acquisition was initially thought as an opportunity to better understand the retail business, but Browns' boutiques later served as incubators to the Store of the Future technology.

Industry Overview

Farfetch is simultaneously a technology, e-commerce and luxury fashion company. It employs technology to offer e-commerce solutions to its customers through its own marketplace or through the platform services provided, but it is highly dependent on the performance of the luxury fashion industry.

The luxury fashion industry is large, highly fragmented and characterized by market trends that have been reshaping the luxury fashion industry over the last decade, imposing a new competitive landscape that demands innovation and entrepreneurship. But not everything is bad news. In fact, luxury is back on fashion, and the market for personal luxury goods reached a record of €262 billion in 2017, a 6% growth since 2016, and can possibly reach €305 billion by 2020. **Exhibit 8** presents the historical performance of the luxury goods market.

In 2017, the personal luxury market experienced growth across all regions, with Asia outperforming the other regions, particularly driven by China. Historically, consumers of luxury fashion have mostly been from western markets. However, in the foreseeable future, the growth of the personal luxury market is expected to come from emerging markets.

The luxury fashion industry is going through a demographic transition. It used to be dominated by Baby Boomers and Generation X and it is now being conquered by Millennials and Generation Z, which represented 44% of all personal luxury goods' consumers in 2017 (**Exhibit 9**). According to Bain & Company, this generational shift was the main driver of growth in the luxury fashion industry in 2017, having contributed with 85% of it. The "Millennial State of Mind" is permeating the luxury industry and pushing high-end brands to recognize and find ways to connect their products and services to their young costumers.

Along with the generational shift came the need for digitalization. Social media profiles of the most followed bloggers, influencers and celebrities are the new fashion magazines, influencing consumer's purchasing decisions with inspiration and fashion trends (**Exhibit 10**). Taking the social leap has proven to be key in engaging with customers. Nowadays most top players of the luxury fashion industry have conquered digital channels and have a strong presence across the main social media networks, such as Facebook, Instagram, YouTube and Twitter (**Exhibit 11**). The most prestigious brands now compete, not only on the quality and design of their products but also on the boldness of the content they publish on social media.

Similarly, the online has been gaining importance in the luxury fashion market and the online sales share of personal luxury goods increased by 24% between 2016 and 2017. However, it still accounts for only 9% of the whole market (**Exhibit 12)**, standing significantly behind other retail markets. Online sales of personal luxury goods are expected to burst in the years to come and should make 25% of the market by 2025.

Going Public

When earlier this year Carmo heard about Farfetch's plans to go public in late 2018, she was not surprised. Three years earlier, Neves once said that "going public would be the next financial milestone for Farfetch" and, since then, the market has been waiting for the moment in which the UK-based company files for an IPO in the London Stock Exchange (LSE).

The main purpose of the offering would be to facilitate access to the public equity markets, raise additional capital and allow Farfetch to use its publicly traded stock as a currency in future acquisitions. Also, the offering was expected to increase the visibility and brand recognition of Farfetch, particularly of the Farfetch Marketplace. The net proceeds of the offering would be used to fund working capital, incremental growth, and, eventually, acquisitions. Nonetheless, going public would require Farfetch to publicly disclose operating and financial information and be subject to tighter control and monitoring. Moreover, public companies are subject to additional pressures from the market, which sometimes leads them to focus more on short-term results than on long-term growth.

Mr. Neves was aware that IPO gains would only come at a cost and his lifetime hard-work was at stake. It is simply unpredictable: the IPO could either be well received by the market or it could be a complete disaster. But Farfetch did it. On August 20th, 2018, it filed documents for an IPO with the US Securities and Exchange Commission to go public in the New York Stock Exchange (NYSE). And the market was stunned. While it expected the company to go public in London, when rumors about Farfetch's intention to go public in New York started to circulate no one expected it to choose the NYSE over the NASDAQ, as the latest is home to the largest technology companies. **Exhibit 13** compares the NYSE and the NASDAQ main features.

Dual Class Structure

When Mr. Neves first thought about Farfetch, he had a long-term project for it and maintaining control while raising capital from private investors or while taking the company public was crucial. As of the 1st of August 2018, Farfetch had a dual class structure with around 211 million class A ordinary shares and almost 43 million class B ordinary shares. **Exhibit 14** contains information about Farfetch's pre-IPO shareholder structure. Mr. Neves was the only owner of Farfetch's class B ordinary shares and, because of the twenty-to-one voting ratio between Farfetch's class B and class A shares, he was in control of 80.2% of the total voting power. Other members of the company's management team and board of directors (more information about their background on **Exhibit 15**) were the beneficial owners of 3.1 million class A shares.

Dual or multi class structures are commonly found among technology companies such as Google, Facebook, LinkedIn and Dropbox and are typically set up to retain control among founders and top executives of a company. According to PwC Capital Markets, dual class IPOs have been increasing in percentage of total IPOs since 2015 (**Exhibit 16**) and in the first half of 2018 there have been as many dual class listings as in the entire year of 2016. Additionally, from 2015 onwards, dual class listings have outweighed non-dual class listings in terms of deal size as illustrated in **Exhibit 17**.

Despite being on the rise, dual class IPOs have been the matter of great discussion. Supporters of dual class structures argue that it gives founders the ability to carry out long-term plans without having to worry about activist investors or the typical Wall Street mindset that tends to focus on short-term results (Bebchuk, Lucian and Kastiel, Kobi (2017)). Moreover, as argued by Cremers, Martijn et al. (2018), protection against hostile takeover attempts is higher under dual class structures. Also, Baran, Lindsay et al. (2018) found evidence of a positive relation between insiders' control and innovation output, which in turn increases long-term firm value.

On the other hand, as argued by Masulis, Ronald et al. (2009), dual or multi class structures increase agency costs and destroy firm value when they hand power to a group of few individuals with low ability, who can then make reckless decisions such as bad acquisitions and investments, take unnecessary risks or benefit from overgenerous perks at the cost of common shareholders. Furthermore, a study from Kim, Hyunseob and Michaely, Roni (2018) shows that, while companies with dual class structures benefit from a 6 to 7% higher valuation when they go public, they experience a 7 to 9% larger decline in Tobin's q[11] ratio as they age.

Exchanges around the world hold different views about dual class listings. A few years ago, only U.S. exchanges like the NYSE and the NASDAQ allowed dual class listings. Asian exchanges such as the Hong Kong Stock Exchange (HKEx) and the Singapore Stock Exchange (SGX) have recently lifted a ban against dual class listings and, while in the U.K. there isn't an absolute ban, the practice is highly discouraged and only permitted under the Standard Listing Regime, which is less attractive to investors.

Market Conditions

In 2016, the IPO market seemed to be entering into hibernation due to political turmoil and market uncertainty, but 2017 saw the IPO Window[12] opening (**Exhibit 18)**, with the number of IPOs growing almost 50% in 2017, compared with the previous year. In the United States, 2018 has been a busy year so far. In the first 6 months, there have been 113 IPOs, raising more than $32 billion, an increase of 30% from the same period in 2017 and more than four times that of 2016 (**Exhibit 19**). The technology sector has been one of the busiest sectors as far as IPOs are concerned. Carmo gathered information about some recent IPOs of the sector (**Exhibit 20**).

Also, in the U.S., the first nine months of 2018 have seen an increase in interest rates and a slowdown of equity capital markets. See **Exhibit 21** for selected capital markets data.

Financial Performance

Farfetch is proud to say that it operates a capital-light business model. Through the Marketplace, the company enables business-to-customer transactions, holding almost no inventory[13] (**Exhibit 22**), and receives a commission (the Third-Party Take Rate) over the Gross Merchandise Value (GMV) traded on the platform. The Cost of Revenue is not given by the merchandise sold through the platform but by transaction processing fees, custom duties and shipping costs[14], among others.

In the first half of 2018, Farfetch's revenues grew 55% in comparison with the same period of 2017, reaching $268 million (**Exhibit 23**). For the year ending December 31st, 2017, Farfetch

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[11] Tobin's q ratio is the ratio between the market value of a company's assets, measured by the market value of its outstanding equity and debt, and the replacement cost of the company's assets given by the book value

[12] Period in which the market is characterized by a combination of high valuation and low volatility

[13] As of the 31st December 2017, Farfetch had $51 million in Inventory

[14] Customs duties and shipping costs are passed on to customers, being offset in Fulfillment Revenue, unless free shipping is offered

reported $386 million of revenue, an increase of 59% from 2016, driven by growth in the GMV[15] and a higher Third-Party Take Rate, which reached 32.9% in 2017, significantly higher than the take rate of giants such as Amazon (10-15% depending on the category). **Exhibit 24** presents Farfetch's key operating and financial metrics.

Even though Farfetch has grown exponentially over the years, it hasn't turned the unprofitability page yet. In the year ended on December 31st, 2017 the company generated a negative cash flow from operating activities in the amount of $48 million (**Exhibit 25),** mainly driven by huge losses. In that same year, Farfetch registered an operating loss of more than $94 million, due to large operating expenses in operations, technology and demand generation. However, the operating margin has been increasing over time, from negative 40% in 2015 to negative 24% in 2017, and the company is confident that it will become profitable soon. Yet, it does not anticipate any dividend payment in the foreseeable future.

The company is often labelled the "Amazon of luxury" and Carmo believes there are many similarities between Farfetch and the e-commerce giant. However, her colleague disagrees with this view and argues that the company is more similar to Yoox Net-a-Porter[16]. Carmo collected operational and financial information about these two companies as can be seen in **Exhibit 26**.

The offering

According to the front page of the final version of the Prospectus (**Exhibit 27**) Carmo got access to, Farfetch will be offering a total of 44,243,749 class A ordinary shares, of which 33,609,381 will be issued by the company and 10,633,858 will be sold by existing shareholders. See **Exhibit 28** for more information about the selling shareholders. The company hired Goldman Sachs, JP Morgan, Allen & Company and UBS, among others, to advise and guide them in the IPO process and underwrite the shares to be offered.

The underwriters have the right to exercise a Greenshoe Option up to 15% at the initial offering price provided that investor interest exceeds what is expected. Moreover, Mr. Neves and other shareholders of the company will be subject to a 180-day lockup period. Concurrently to the

[15] Growth in GMV was primarily driven by growth in the number of Active Customers and growth in frequency of orders of Active Customers

[16] Yoox Net-a-Porter is the largest online luxury fashion retailer

IPO, Kadi Group, a subsidiary of JD.com, will purchase 1,361,635[17] additional shares (at the IPO price) through a Private Placement.

The initial price range was originally set at $15-$17 per share, then revised upwards to $17-$19 and now the final price was set at $20 per share. At $20 per share Farfetch is targeting a valuation of around $5.8 billion but Carmo believes that such valuation might be a little far-fetched for a company that is currently operating at a loss. However, she is aware that valuing a company like Farfetch is difficult. Estimating the company's cash flows is extremely complex. Will Farfetch ever turn into positive cash flows and if so, when? How big will they get? What is the appropriate discount rate for this company? And if investors usually rely on the valuation of comparable publicly traded companies, the job doesn't seem to get any easier that way. Who are the right comparable companies for Farfetch? What is the appropriate valuation multiple? Carmo gathered information about several possibly comparable companies, as can be seen in **Exhibit 29**.

Verdict

Carmo faces many important decisions ahead. Farfetch has grown exponentially in the last few years but it hasn't generated any operating profits yet. Will Farfetch turn the unprofitability page any time soon? At the same time, Farfetch is set to go public with a dual class structure that gives Mr. Neves over 77% of voting power post-offering. Is the dual class structure appropriate for this company or will it possibly raise corporate governance issues in the future? Also, Carmo sees the IPO valuation as too high.

[17] One-third of the number of shares Kadi Group would have to purchase to maintain its pre-IPO holding percentage. Kadi Group will not purchase any additional shares in the event that the underwriters exercise their blic