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REAL.OQ - Q4 2019 RealReal Inc Earnings Call

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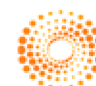

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the RealReal Fourth Quarter 2019 Financial Results Conference Call. (Operator Instructions)

It is now my pleasure to hand the conference over to Head of Investor Relations, Paul Bieber.

Paul Judd Bieber - *The RealReal, Inc. - Head of IR*

Thank you. Good afternoon, and welcome to the RealReal's earnings call for the quarter ended December 31, 2019. I'm Paul Bieber, Head of Investor Relations at the RealReal. Joining me today to discuss the RealReal's results are Founder and CEO, Julie Wainwright; and CFO, Matt Gustke. Julie will provide an update on our business, including key initiatives, and then Matt will review our Q4 financial results and provide a financial outlook.

Before we begin, I'd like to remind you that management will make forward-looking statements during the course of this call, and our actual results could differ materially. Some of the risks and uncertainties that could impact our business are included in our final prospectus for our initial public offering filed with the SEC on June 27, 2019, and the risk factors included in our Form 10-Q that was filed with the third quarter financial results and the Form 10-K that will be filed with our fourth quarter results.

In addition, our presentation will include non-GAAP financial measures, and we have provided reconciliations to the most comparable GAAP measures in our earnings press release, which is available on our Investor Relations website.

I would now like to turn the conference call over to RealReal's Founder and CEO, Julie Wainwright. Julie?

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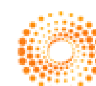

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Julie Wainwright - *The RealReal, Inc. - Founder, President, CEO & Chairperson*

Thanks, Paul. Good afternoon. Thank you for joining us today to discuss our fourth quarter 2019 financial results.

I'm happy to report that in 2019, we generated more than $1 billion in GMV. The RealReal has clearly come a long way from my early days where my COO, Rati Levesque, and I discussed strategy at my kitchen table while we also did all the work, including answering customer service calls, et cetera, et cetera. A long way. A big thank you to our consignors and our buyers who helped us achieve this milestone.

By recirculating goods, you're creating a more sustainable world by also making money from the luxury items you no longer use. Of course, the RealReal success is due to the dedication and diligent efforts of our employees. You have made the RealReal the safest and most service-oriented marketplace to buy pre-owned luxury goods. Thank you so much.

Before discussing our financial results, let's take a moment to discuss the RealReal's authentication process. There is no other resale company doing more to remove fakes from the market every day and to put counterfeiters out of business. We believe we have the most rigorous authentication process in the marketplace as we authenticate every item we sell using the combination of technology and trained experts. On our previous call, we discussed how automation of copywriting and pricing is changing the roles of our teams. In 2020, copywriting and pricing will be mostly automated. The combined impact of automation and leveraging technology has dramatically changed our team's day-to-day activities in our operation centers. The net effect of this has allowed us to process more products daily per person while also expanding the depth of our authentication process, training and quality control procedures.

Importantly, our processes will continue to evolve as we integrate more technology throughout 2020, and of course, we have to evolve as counterfeiters also evolve.

Our goal is to be the safest marketplace to buy pre-owned luxury goods. Our NPS buyer score of 71 and the fact that over 80% of GMV came from repeat buyers and consignors in 2019 indicate that we are certainly focused on the right issues.

Now for the financial highlights. And as always, Matt will provide more color after my comments.

In Q4, we achieved 39% year-on-year GMV growth, with all top level categories experienced growth in excess of 25% year-on-year. Handbags, followed by men's, were the fastest growing categories. At the same time, Q4 adjusted EBITDA margin improved by approximately 17 percentage points year-on-year, driven by operations and technology expense leverage, and our planned reduction in marketing spend. Our Q4 results highlighted our most disciplined focus on driving variable expense leverage, which is an important driver of path to profitability.

For the full year 2019, we generated GMV of $1.008 billion, up 42% year-on-year. We also made significant progress on our path to profitability as our adjusted EBITDA margin improved by 540 basis points year-on-year, while making significant investments that position us to capitalize on the massive opportunity in front of us.

Needless to say, we had a good year last year, but we don't rest on our past successes. Here are our 4 strategic priorities for 2020: number one, a continued focus on growth; number two, driving leverage in operations and marketing; number three, expanding our retail footprint; and number four, sustainability. Our first priority is to continue our strong GMV growth. We are convinced there is much more growth in front of us than behind us as each year, consumers purchase hundreds of billions of dollars of personal luxury goods. These goods accumulate in their homes over time and create a massive market opportunity for us. Frost & Sullivan estimates the total value in U.S. luxury goods potentially available for resale at approximately $198 billion. Clearly, we are at the beginning of a very large opportunity.

Unlocking supply is the key to our growth. To that end, in 2020, we will continue to invest in growth through expanding our retail footprint, making appropriate investments in marketing and growing our sales team. Importantly, scale and growth are essential inputs to our path to profitability. We benefit from scale to leverage fixed costs and to drive unit level efficiency so our investments in growth are 100% consistent with driving toward profitability.

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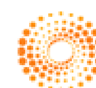

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Our second but equally important priority is driving leverage. A big part of our 2019 margin improvement was driven by our marketing efficiency and investments in automation, both helped facilitate our ability to scale and contributed to significant improvements in our order economics. For marketing, marketing as a percent of revenue in 2019 was only 15% and helped drive 42% GMV growth. This resulted in our buyer acquisition cost, known as BAC, declining approximately 30% in the fourth quarter and approximately 20% year-on-year in 2019. This was our third consecutive year of BAC decline. Clearly, our flywheel effect is positively impacting our business as buyers become consignors and consignors become buyers.

We believe there is additional opportunity to improve marketing leverage going forward by: number one, buyer retention, 82.9% of our GMV came from repeat buyers in Q4; number two, the continued impact of the network and flywheel effect; number three, continued media mix optimization; and finally, number four, conversion to buyers from our large member base.

In 2019, we achieved operations and technology leverage, primarily through the automation of our inbound processes. We exited the fourth quarter automating the pricing of 61% of our unit volume, 27% of our copywriting, including product title and description, and 21% of our federal retouching. We will continue to invest in automation in 2020, and we expect to see steady increases in the percent of items with automated copy and retouching, which will support improvements in inbound processes unit costs and help us continue to increase the scalability of our operations. We will also invest in technology to further improve the efficiency of our pick, pack and ship operations.

Moving to our third strategic priority, expanding our retail footprint. We operate in an omnichannel marketplace, and our retail stores are an important asset in that strategy. Our retail stores redefine the luxury consignment shopping experience and offer our buyers a highly curated selection of products that are refreshed daily. We opened our first store in SoHo in New York City in November of 2017, followed by our West Hollywood store in July of 2018. In early 2019, we opened a small footprint store in New York on the Upper East Side on the corner of Madison and 72nd, that's in case you just want to stop by. Our stores drive supply and remarkable sales per square foot, have high average order values and very low return rates. They also drive brand awareness, and we believe that creates a halo effect in the local market.

In 2019, our 3 retail stores generated approximately $150 million of value to our marketplace, including $65 million in demand and approximately $85 million in supply. So we feel very good about their momentum. We are very proud of our SoHo store, which opened in November 2017, and it continues to perform incredibly well. In Q4, the SoHo store generated GMV growth of 36% year-on-year, only slightly below our total GMV growth rate in the quarter and an enviable growth rate for a store in its third year of operations. In 2020, we expect our San Francisco stores to open in Union Square sometime in March. We're also excited to announce that we recently signed a lease for our flagship store in Chicago on Michigan Avenue. We expect that store to open in the second half of 2020. While we are pleased about our retail momentum, our retail strategy will continue to be deliberate and opportunistic.

I'd like to wrap up today with an update on sustainability. For perspective, 73% of the world's clothing eventually ends up in landfills, according to Global Fashion Agenda. And as we have stated before, every second, the equivalent of 1 garbage truck of textile is landfilled or burned. With that in mind, we are pleased to update our sustainability metrics. Since inception through December 31 of last year, consignment with The RealReal has offset 13,300 metric tons of carbon and saved 608 million liters of water. Given the importance of sustainability to The RealReal and our customers, we believe it's important to take concrete action as a thought leader in sustainability. In November of last year, we were the first company to take the pledge in the CEO Carbon Neutral Challenge issued by Gucci CEO, Marco Bizzarri. The RealReal has pledged to be carbon neutral in 2021.

As a final note, we are pleased to see the momentum of resell in the marketplace as more companies embrace the circular economy. And we're happy to welcome Nordstrom's commitment to driving sustainability in the fashion industry.

With that, I'll turn the call over to Matt for the numbers.

Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

Thanks, Julie, and good afternoon, everyone.

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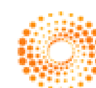

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We had a strong Q4, highlighted by 39% year-over-year GMV growth and 17 percentage points of adjusted EBITDA margin leverage, underscoring our continued focus on balancing growth with a disciplined approach to driving operating leverage.

Moving on to our key operating metrics. We ended Q4 with 582,000 active buyers on a trailing 12-month basis, up 40% year-over-year. We added approximately 39,000 net new active buyers quarter-over-quarter. GMV from repeat buyers was 82.9% of total GMV in Q4, up 130 basis points year-over-year, reflecting strong buyer retention in the period. We generated $303 million in GMV, an increase of 39% year-over-year, which we are very happy with given that our marketing spend was down 14% year-over-year as planned. Trailing 12-month GMV per active buyer was approximately $1,733, up 1% year-over-year. Q4 orders were approximately 637,000, up 35% year-over-year. Q4 AOV was an all-time record at $476. The 2% year-over-year AOV increase was driven by an increase in average selling price per item, while units per order were flat year-over-year.

Returns and cancellations were 27.6% of GMV and improved 210 basis points year-over-year, driven by lower return and cancellation rates. Our Q4 consignment take rate was 36.2%, an increase of 130 basis points year-over-year, reflecting the impact of our Q1 2019 commission changes. We expect Q1 2020 take rate to increase modestly year-over-year, and we expect a modest increase for the full year 2020 as we fully anniversary our February 2019 take rate adjustments. We also note that take rates can vary from quarter-to-quarter based on the mix of products sold as well as which consignors had item sales. In the steady state, we expect take rates to be highest in the second and third quarters of the year and to decrease in Q4 with a higher mix of high-priced products.

Total revenue in Q4 was $97.3 million, an increase of 57% year-over-year. Q4 consignment and service revenue was $80.7 million, up 46% year-over-year. Direct revenue was $16.6 million. Direct revenue includes a reclassification of approximately $6.8 million of consignment revenue to direct revenue and a corresponding decrease in consignment revenue of approximately $2.3 million, reflecting an adjustment in the timing of title transfer for a subset of our out-of-policy returns. There was no change to prior year reported numbers due to this reclassification. The reclassification also had no impact on GMV or gross profit, which we believe are the best measures of the scale and growth of our marketplace, nor did it impact adjusted EBITDA.

Q4 gross profit was $62.5 million, an increase of 48% year-over-year. Gross profit per order increased by 10% year-over-year to $98, driven by higher AOV, take rates and shipping leverage. For the full year 2019, gross profit per order increased 7% to approximately $92. We see the potential for gross profit per order to exceed $100 over the next few years, primarily driven by improvements in shipping expense. Q4 consignment gross margin was 74.0%, down 100 basis points year-over-year, driven by the reclassification described previously. Excluding the reclassification, consignment gross margin was essentially flat year-over-year.

Direct gross margin was 17.2%, up approximately 430 basis points year-over-year due to improved product margins. As a reminder, direct gross margin is lower than consignment gross margin because direct revenue is recognized on a gross basis with corresponding cost of sales.

Moving on to operating expenses. Please note that I'll speak about OpEx on a non-GAAP basis, excluding equity-based compensation and related taxes. For a reconciliation to GAAP, please refer to our earnings release.

Marketing expense was $10.8 million in Q4, a decrease of 14% year-over-year. Q4 marketing as a percent of revenue improved to 11.1% compared to 20.3% in the same period a year ago. Our Q4 BAC improved by approximately 30% year-over-year, and full year BAC improved by 20% to $114. As we discussed on our Q3 call, we decided to reallocate marketing dollars to earlier quarters where the ROIs were more attractive, resulting in a decline in absolute marketing expense in Q4. While this approach resulted in 900 basis points of year-over-year leverage in the period, we will take a more balanced approach to the cadence of our 2020 marketing spend.

As Julie mentioned, we believe there is additional opportunity to improve marketing leverage going forward, but marketing leverage will vary from quarter-to-quarter based on the timing of our advertising spend. Operations and technology expense, which includes costs relating to our stores, luxury consignment offices, fulfillment centers, merchandising, engineering and product management, was $38.9 million in Q4, an increase of 22% year-over-year. Operations and technology as a percentage of revenue was 39.9%, an improvement compared to 51.5% in the same period a year ago. Productivity improvements in our inbound operations from our automation investments, improved efficiency in our pick, pack and ship operations, and fixed expense leverage drove significant operations and technology expense leverage in Q4. We believe there is additional

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opportunity to improve operations and technology leverage going forward, driven by automation, improved outbound efficiencies and fixed expense leverage.

Selling, general and administrative, or SG&A, expense was $32.9 million, up 73% year-over-year. SG&A as a percent of revenue was 33.9% compared to 30.6% in the same period a year ago, driven by investments in our administrative function head count to support being a public company as well as other public company costs, and a onetime $3.2 million donation to establish The RealReal Foundation. Excluding onetime costs, SG&A as a percent of revenue was 30.3% compared to 30.6% in the same period a year ago. Our adjusted EBITDA loss for Q3 was $12.7 million or 13.1% of revenue, an improvement of approximately 17 percentage points year-over-year. At the end of Q4, cash, cash equivalents and short-term investments totaled $363.3 million.

Before I move on to guidance, I'd like to touch on buyer cohort performance and contribution profit per order. Overall, our annual buyer cohorts remain healthy and consistent. For the annual cohorts where we have at least 3 years of data, 2019 GMV per cohort increased by approximately 10% year-over-year on average, and each of these cohorts saw year-over-year growth.

Moving on to contribution profit. Internally, we focus on contribution profit per order and view it as an important metric to assess our marginal profitability and measure our progress on driving operating efficiencies. Contribution profit is calculated by subtracting variable marketing, operations, sales and merchandising expenses from gross profit. Fixed expenses include occupancy, general and administrative, technology, marketing and certain merchandising head count costs. 2019 contribution profit per order was $19.72, an increase of 126% year-over-year. This improvement was driven by a $6 increase in gross profit per order and a 7% decrease in variable expenses, primarily variable marketing and inbound operations expenses. Contribution margin as a percent of revenue was 13.8%, up 700 basis points year-over-year. We expect contribution profit per order will increase substantially again in 2020 due to: one, continued growth in gross profit per order, driven primarily by shipping expense improvements and, to a much lesser extent, from higher AOVs and take rates; two, continued improvement in our BAC and high buyer retention; and three, continued improvement in variable operation expenses from our automation investments and improved efficiency in our pick, pack and ship operations. The combination of our improving contribution profit per order and high buyer repeat rates increases our confidence in our ability to drive margin expansion as we begin to leverage our fixed expenses over the coming years.

Moving on to guidance. For 2020, we expect GMV of $1.315 billion to $1.345 billion, representing a year-over-year growth rate of 30% to 33%. This guidance reflects our San Francisco store opening in March and Chicago store opening around the end of the third quarter. Further, we do not expect a significant change in year-over-year take rate, and we do expect direct revenue to decrease year-over-year as a percent of total revenue. Therefore, revenue growth rates will be much closer to GMV growth in 2020 than it was in 2019. We expect our 2020 adjusted EBITDA margin loss percent in the range of 15% to 16%, which represents 700 to 800 basis points of year-over-year adjusted EBITDA margin leverage, which is more leveraged than we delivered in 2019. We expect the following factors to drive operating leverage in 2020. One, gross profit per order. We expect gross profit per order to increase year-over-year, driven primarily by shipping expense improvements. These shipping expense improvements, together with the lower direct sales as a percent of revenue, are expected to drive year-over-year gross margin expansion of approximately 500 basis points in 2020. Second, marketing. We expect our BAC to continue to decline, driving a year-over-year improvement in marketing as a percent of revenue. Third, ops and tech. We expect a year-over-year improvement in ops and tech as a percent of revenue, reflecting automation and fixed expense leverage, partially offset by investments in new retail stores and in technology. Fourth, SG&A. We expect our investments in public company expenses to flatten out during 2020 and to begin seeing leverage in SG&A in the second half of the year.

Overall, we expect to achieve adjusted EBITDA breakeven in Q4 2021 and full year adjusted EBITDA profitability in 2022. As I mentioned earlier, we are planning a more even cadence to our quarterly marketing spend in 2020, and therefore, we expect a fairly consistent year-over-year GMV growth rate throughout the year. Therefore, for Q1, we expect GMV of $291 million to $295 million, representing a year-over-year growth rate of 30% to 32%. We expect Q1 adjusted EBITDA margin loss percent in the range of 24% to 26%, reflecting investments in store openings, higher quarter-over-quarter marketing investment and higher quarter-over-quarter spend in SG&A to support supply growth and public company costs.

A few additional notes for those building models. We do not anticipate investing in our next fulfillment center until 2021. We expect approximately $20 million to $22 million in stock-based compensation expense in 2020. We expect approximately $18 million to $20 million in depreciation expense in 2020, and we expect approximately $30 million to $34 million of CapEx in 2020. Our fully diluted share count, including RSUs and unvested options as of December 31, 2019, was $95.8 million.

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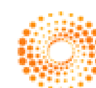

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In closing, we are proud to cross the $1 billion GMV milestone in 2019 and are confident there will be much more growth ahead. In 2020, we will continue to focus on top line growth, and we'll do so with increasing operating leverage as we drive toward profitability in Q4 2021.

With that, we will open the line for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Justin Post with Bank of America.

Justin Post - *BofA Merrill Lynch, Research Division - MD*

Great. And congrats for reaching $1 billion in GMV. I guess the first question is, it looks like you really are getting strong repeat rates, both from buyers and consignors. And I was just wondering, what are your strategies next year as you try to target new customers and bring them into the funnel? Because it looks like you do a pretty good job of retaining them. So maybe we can start with that. And then I have a follow-up.

Julie Wainwright - *The RealReal, Inc. - Founder, President, CEO & Chairperson*

Okay. I'm going to answer that. We actually have a very healthy growth of new customers also and new consignors. So our strategy sort of remain the same, which we use our current member base, which is growing pretty aggressively, to recruit buyers and then also consignors. We also -- our stores have turned out to be an interesting way for us to get both new buyers and consignors. Even SoHo in its third year is still attracting a very large percentage of new. But primarily, it's performance marketing, to first get someone to be a member and then convert them to a buyer or a seller. And our performance marketing is still primarily driven by media, not digital. So advertising on regional cable and also some over-the-top media. But -- and just for perspective, we've always had -- for the last few years, we've always been in the 80% rate from a repeat basis, which speaks to the value of the business to both the consignors and the buyers.

Justin Post - *BofA Merrill Lynch, Research Division - MD*

Great. And Matt, just on the cadence of GMV, looks like some deceleration in Q1 and then you're kind of expecting it to be flat at that level for the year. I know there could be some volatility on the comps, but just maybe dive into that a little bit and explain your thinking around the GMV growth outlook for the year.

Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

Yes. Sure. So I'm actually going to go back a little bit. You'll remember that our Q3 growth rate was nearly 50% in terms of GMV. That quarter included a pretty significant bump around the IPO. Q4's growth was basically in line with what we saw prior to Q3, around 40%. And though there was some impact from having the lower marketing spend in the quarter, we're really happy with the results in terms of the leverage and delivering our first-ever quarter of positive operating cash flows. But in hindsight, we may have been too aggressive in our approach because the Q4 reduction did have some carryover in terms of Q1 growth rates for our new consignment leads and new buyers, to your first question.

Repeat buyer and consignor performance remains very strong, including in the quarter. So while we did successfully optimize for marketing ROI in 2019, we're going to take a more balanced approach in 2020, which results in the more even year-over-year growth rate you see over the year. And to your point, there are some minor fluctuations due to the comps, but more or less an even growth rate. That will help in a number of ways, including allowing us to optimize our labor planning a lot better because, in our operations, swings up or down can lead to pretty substantial inefficiencies. So we're going to just be more balanced going forward. And the results are as I guided.

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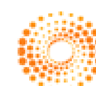

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And our next question comes from the line of Edward Yruma with KeyBanc Capital Markets.

Edward James Yruma - *KeyBanc Capital Markets Inc., Research Division - MD & Senior Research Analyst*

My congratulations as well. Obviously, some very well documented issues in the [first part of your] luxury industry with impact of coronavirus. I guess are you seeing an impact from higher promotional levels on the first-party kind of filtering down to what you do? And then second, it sounds like some very promising signs kind of in your physical store rollout. Post-Chicago, should we expect kind of a regular cadence of store openings, given some of the strong results that you're seeing?

Julie Wainwright - *The RealReal, Inc. - Founder, President, CEO & Chairperson*

So I'll take some, and then I'll let Matt jump in. So we're not seeing any impact of the coronavirus at all, certainly not on the promotional front or in any other level. And just so you know, our exposure in Asia is less than 2%. I think it's about 1.2%, to be specific. So at least now as it's contained in the U.S., we don't expect to see any promotional impact or any impact otherwise. On the store basis, again, I think you might remember, we look for a great location, a good rent and key strategic cities. So right now, we still think it's about 2 stores a year for the next foreseeable future. That may vary by 1 store, plus or minus. But I would expect, given -- we expect a great performance out of San Francisco coming home. Chicago in the summer, we think, will also be fabulous for us, and we're already looking at our next stores. But again, I wouldn't expect more than 2 to 3 a year and probably closer to 2.

Edward James Yruma - *KeyBanc Capital Markets Inc., Research Division - MD & Senior Research Analyst*

Great. And Matt, one quick follow-up. I know you were fairly clear on the marketing spend. But just so I'm crystal clear, is it literally going to be kind of even every quarter? Is there a bit of catch-up in the first quarter from the softer fourth quarter marketing spend? And just maybe help us understand the shape of that maybe a little bit more explicitly.

Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

Yes. And without getting too granular, so Q1 quarter-over-quarter is a fairly substantial increase in dollars, and then fast forward to the fourth quarter. So in 2019, the biggest things we just -- we pulled forward a decent amount of our Q4 spend into earlier quarters, mostly into Q3, but even a little bit into the first quarter. In Q4 of 2020, we do expect to see year-over-year growth in marketing dollars, but perhaps not as high as -- some are in between what we did in '19 and 2018. So it's a moderation of the strategy. The strategy was successful, but we just feel we should kind of stretch it or smooth it out a little bit.

Operator

And our next question comes from the line of Michael Binetti with Crédit Suisse.

Michael Charles Binetti - *Crédit Suisse AG, Research Division - Research Analyst*

Sorry, I got -- I had to redial, and so I apologize if I missed anything on Q&A. But Matt, I just wanted to clarify, I think earlier, you said you expect the take rate guidance to be modestly higher year-over-year, but only in the first quarter, right? I think you said later that you expect it to be flat, flattish.

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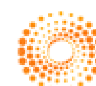

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Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

Yes. Well, that's actually not what I said, but I actually also misspoke earlier. So take rate in Q1 will be up fairly substantially between 50 and 100 basis points year-over-year. For the full year, it will be up modestly. So obviously then, beyond Q1, you're talking about roughly flat year-over-year, [weighting up] to tens of basis points on the full year.

Michael Charles Binetti - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. So that's basically the wraparound of the price increase from last year in the first quarter and then no planned rate increases for the rest of the year, I think, is how to think about it.

Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

That's right.

Michael Charles Binetti - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. And then I heard you answering a question around GMV at the end, but I'll just ask a little bit differently. I mean Julie pointed out the SoHo stores in year 3 is trending at 36% in your biggest market. I mean these are some of the more mature businesses that you would think would be on the front end of any kind of normalization in the growth rate, but then you're guiding for GMV in the first quarter to slow pretty meaningfully from what we've seen in the last 2 quarters. How much conservatism would you say is in that number versus something you're seeing in the trends in the business today that led to the guidance?

Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

The guidance reflects the trend -- I mean, well, we're nearly 2 months into the quarter, right? So the guidance reflects the trends that we've seen quarter-to-date. And it's largely due to the marketing spend we're talking -- we've been talking a lot about. A substantial reduction in marketing spend had a little of impact in Q1, actually, a bit of a bigger impact -- sorry, a little bit of impact in Q4, a little bit bigger impact in Q1. We have since ramped up our marketing spend substantially quarter-over-quarter, therefore, our confidence that we'll sustain these growth rates as we get into the second quarter and beyond.

Michael Charles Binetti - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. And if I could just ask one last one. You mentioned a couple of times through the prepared remarks the leverage in the year on shipping would be a major call-out this year. Could you just walk us through, in reality, what are some of the changes in the shipping that's driving some confidence in the leverage there, please?

Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

Yes. There's a lot of things, but there's a couple of major ones that I'll call out. First is renegotiating our contract with our primary shipping carrier, UPS. That took place right at the very end of 2019. So we already started seeing some benefits as we came out of the year. So we'll have a full year benefit of lower rates. Second, as you recall, we opened our Perth Amboy Warehouse, and we started shipping in roughly May of 2019. As that facility started ramping up, we saw an increase in the percent of our orders that have split shipments. So that continued to increase and frankly is kind of yet to peak, but it's getting there. But we anticipate that as we get into this year, that the split shipments will peak and start coming back down. So you'll have kind of a twofold benefit on shipping.

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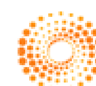

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Operator

Our next question comes from the line of Oliver Chen with Cowen.

Oliver Chen - *Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst*

Regarding average order value, what are your thoughts about how that may trend going forward as you think about both the interplay, the product mix? And what does your guidance assume for what you're seeing in the promotional environment as well?

Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

Yes. So AOV in Q4 was a record high. And actually it's quite high given a higher mix of gifting products. There was a lot of jewelry, a lot of handbags, in particular, that sort of drove our record-high AOV in Q4. Q1 is going to come back down, as it always is. So our guide for the year essentially assumes basically flat full year AOV. Maybe it's up about a point, but flat to up a few dollars, in essence. And our expectation for the promotional environment is that it's much like it was in 2019, which means that we will see a Q3 decrease quarter-over-quarter in AOV and a substantial increase again in Q4.

Oliver Chen - *Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst*

Okay. And another modeling question. When we look over longer term for marketing as a percentage of sales and shipping as a percentage of sales, we've made some really great progress so far. Where do you see that going over time?

Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

So I'll start with marketing. So we expect -- and our model assumes that every year for the next few years, we continue to get leverage in marketing. First and foremost, that's driven by our high repeat rates. And that, we expect to see the percent of GMV from repeat buyers and consignors to continue to increase consistently and modestly every year. So the amount of money that we need to spend on growth decreases. And then furthermore, we expect our BAC to continue to decline this year and beyond, though at more modest rates than we saw in 2019. Certainly, we don't expect to see 20% year-over-year decrease every year.

And the second was around shipping. So we haven't really built in substantial improvements beyond this year's guide into our thinking. Though, certainly, we're going to continue optimizing our shipping expenses, though, not every time we open a new warehouse, you are going to see the phenomenon of split shipments increasing. And that will kind of peak and then drop down over the course of about a year. But outside of that, you should expect to see relatively steady, maybe modest improvements year-over-year each year.

Oliver Chen - *Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst*

And Julie, as a follow-up, you made a lot of really impressive progress with partnerships with various brands. What do you think is ahead for how you're thinking about partnerships, whether that be with specific brands and/or retailers as well?

Julie Wainwright - *The RealReal, Inc. - Founder, President, CEO & Chairperson*

We actually continue to have continued discussions with multiple brands. And you'll know as soon as we know if it comes into something more than a partnership. But again, as you know, Oliver, it's not critical for us to have the brands as a partner. But we're always in discussions, and some brands are more open and more positively inclined to work with us than others. So discussions are ongoing.

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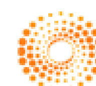

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Operator

And our next question comes from the line of Eric Sheridan with UBS.

Eric James Sheridan - *UBS Investment Bank, Research Division - MD and Equity Research Internet Analyst*

Maybe 2, if I can. When you think about the marketing spend or investments in the business, how is the split between trying to continue to incent more goods and inventory on the supply side of the marketplace versus driving new buyer growth? Is there a split we can get in terms of the way you think about where you need to stimulate more activity in the marketplace, and how we think about that exit '19, and how that will evolve as it goes through 2020?

And the second question would be, from the outside looking in, what signs can you help investors and folks like us in terms of understanding how you might gain additional leverage over the authentication process, especially automation, the machine learning tools over time? Julie, you talked about it a little bit in your prepared remarks. Just wondering if we could go a little bit deeper there and get a little bit more color as we progress through '20 and beyond in what we should be watching for there.

Julie Wainwright - *The RealReal, Inc. - Founder, President, CEO & Chairperson*

I'm going to take the last part, then I'll kick it over to Matt to talk about leverage in marketing and new. So look, the key for us, as you know, because we do take possession, we receive, we write copy, we price, we take photographs and then -- and we authenticate. So the good news is we made tremendous strides on actually auto-copywriting, pricing and photo editing. So that, by focusing more in that area, which are increasingly easier for us to automate, it actually allows us to free up more time for more throughput and deeper authentication. We've also employed machine learning in our warehouse, in our ops. So we route products differently based on the counterfeiting trends that we're seeing and also high-risk consignors. So we've employed machine learning and rules-based technology to route products differently, which makes our process more clean, I would say.

But at the end of the day, everything we're doing is both to automate the tasks that can be automated, which gives us scalability, and then make sure that we're doing the right things on authentication at all times. So we feel really good. Last year was a monumental year where tests we've put in place in 2018 became a practice in 2019. I would say on -- in general, we're probably -- if you just think of getting to the genesis of this and recognizing the potential, I would say we've got a lot more in front of us than what we've actually realized so far. So we're pretty excited about it. Because secondarily, we do pick, pack and ship, and that area has actually had the least automation. So when you look at total ops, from receiving the product to shipping it out, we have a long way to go there. And our model show conservative -- really a conservative cost of the impact of technology, and we're not going to stop there. I think that's the clearest way to say that. And on the other, Matt?

Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

Yes. So on the marketing question, given that the majority, at this point, of our total ad spend is in TV, and that growth as part of our mix continues, our TV ads tend to be buyer-focused, and we've tested seller-focused messaging. And the buyer messages just work better, and they resonate better. So we're not specifically trying to drive more buyers than consignors, but it's just the most effective marketing that we can run. The effect of that is that it brings in -- generally, everyone that comes in becomes a member first. And then we use different levers to convert them typically into buyers first, but we try to convert them from a member into some sort of value-creating activity through e-mail marketing and various other means. So expect that to continue. What we've seen is a consistent growth in buyers versus consignors. We've always had a ratio of about 4 buyers for every 1 consignor. So when we ramp up our marketing, we see that happen. The buyer growth tends to go faster with the consignors catch up and vice versa.

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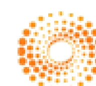

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Julie Wainwright - *The RealReal, Inc. - Founder, President, CEO & Chairperson*

One last comment. We are going to roll out some technology in the next couple of months that actually should help remove even more friction away from the consignors. So we're -- ideally, we are supply constrained, and we can sell everything we bring in by design. So the more friction we remove from the consigning process, the more it accelerates our growth, and we've been working on some technologies that we'll roll out in the next couple of months.

Operator

And our next question comes from the line of Aaron Kessler with Raymond James.

Aaron Michael Kessler - *Raymond James & Associates, Inc., Research Division - Senior Internet Analyst*

A couple of questions. Maybe first, some of the brand awareness, kind of how much room do you think you have left to go there? Kind of our recent survey was showing about 20% brand awareness, up nicely year-over-year, but still kind of seems like a lot of opportunity. And then is there any geographic regions of strength you would call out or new growth areas you're seeing?

Julie Wainwright - *The RealReal, Inc. - Founder, President, CEO & Chairperson*

On the brand awareness, we do the study annually. So you're absolutely right, that's the last numbers that we've seen. We have a long way to go before we become ubiquitous. So I'm looking -- we've always field that study in the April, May time frame, and we do it annually. So we'll let you know as we know. But we have a lot of headroom there. So we're excited about that. What was the second part?

Aaron Michael Kessler - *Raymond James & Associates, Inc., Research Division - Senior Internet Analyst*

Geographic areas that you're seeing.

Julie Wainwright - *The RealReal, Inc. - Founder, President, CEO & Chairperson*

You know what, the truth is, which -- this is sort of like the shoemaker's children have no shoes. The Bay Area actually is sort of a -- was a latent growth market for us. We're seeing an acceleration of growth in the Bay Area, and we expect that to really go even further once the store opens, which will be sometime this quarter. So -- but having said that, the regions are all growing. They're all growing. We're happy about that. But the Bay Area sort of surprised us. Its growth has been accelerating in the last 6 months.

Operator

And our next question comes from the line of Ike Boruchow with Wells Fargo.

Tom Nikic - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

It's actually Tom Nikic on for Ike. Matt, I wanted to get some clarification on the gross margin outlook for the year. You kind of lost me for a second there. I think you said something about 500 basis points of expansion. Did I hear that correctly? That kind of sounds like a lot.

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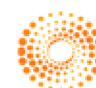

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Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

Yes. You did hear correctly, and it is a lot. The 2 drivers are, again, the shipping expense levers that we talked about a lot at this point; and then having less direct revenue, which has gross margins in the teens, high teens, less of that as a percent of overall revenue; and more consignment revenue, which has gross margins in the low 70% range.

Tom Nikic - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

Okay. Got it. And then just another clarification. I know the marketing expense has been a big topic here. But when you talk about more consistent across the quarters this year, do you mean like the dollars, the actual dollar spend is more consistent across the quarters than it was last year? Or do you mean that the growth rates are more consistent across the quarters?

Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

Yes. Right. The growth rates will be more steady. Said more specifically, we will have year-over-year growth in marketing spend in Q4, whereas last Q4, it was down 14% year-over-year.

Operator

And our next question comes from the line of Rick Patel with Needham & Company.

Rakesh Babarbhai Patel - *Needham & Company, LLC, Research Division - Senior Analyst*

I'll add my congrats on the strong execution as well. Can you update us on the opportunity to convert buyers from your large membership base? I'm just curious if there's any way to contextualize the progress you made in 2019 and what you think works best in terms of driving that conversion.

Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

Yes. I'll start and if you want to chime in, Julie. So we have about 15 million members in our database. So it's a great pool for us to convert from. In any given period, nearly half of our new buyers and consignors are coming out of that membership base. And I -- they weren't added to the membership base in that period. That's been very consistent in terms of converting folks. But again, everything kind of comes back to product. And the more product that we bring in, product feeds not only our repeat business, but it converts members into buyers. It's our best lever to convert. Certainly, our marketing helps quite a bit. And there are certain other technology initiatives that we work on to inch forward the conversion of members into consignors or to buyers. And that's always getting progressively better. And I would expect to see that continue for this year and beyond.

Julie Wainwright - *The RealReal, Inc. - Founder, President, CEO & Chairperson*

Yes. I mentioned before that we're actually rolling out some new technology to remove friction for the consignors. We're -- the focus on technology for the buyers this year is more in personalization. And we -- that's an ongoing project. We're excited about -- we've made some strides last year, but you can expect that to be a key focus for the buyer demand. So we're -- technology has been very successful at driving better conversion all the way along the way for both our buyers and sellers. And this year is going to be another good year for us.

Rakesh Babarbhai Patel - *Needham & Company, LLC, Research Division - Senior Analyst*

Great. And can you also talk -- provide some more color on category performance? I believe you touched on handbags, but curious if you saw any changes in trend in other categories and to what extent you see category mix playing into AOV as we think about the outlook.

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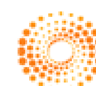

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Julie Wainwright - *The RealReal, Inc. - Founder, President, CEO & Chairperson*

So I'll start off, and Matt can jump in. Yes. We had amazing growth across all of our categories. And handbags and men's really were -- exceeded the overall revenue growth, followed very closely by jewelry. The only category that didn't really just skyrocket out is our beauty, which I bet you didn't even know we did beauty. That's because that's mostly located in our brick-and-mortar stores as a convenience add-on sale.

But all categories grew. Handbags grew faster, men's grew faster than our business. But our women's was still incredibly up. So we really love the fact that we have a balanced category mix, fine jewelry, watches -- fine jewelry and handbags and watches actually have a higher AOV, and they contribute to our overall business. And that's what you saw, especially during the holiday season. We always sell a lot more of those. And it is a gifting site. But having these balanced categories allow us both to have a higher AOV, get greater gross margin dollars, but also offset -- if there is promotional pricing in one category, we can usually offset that by growth in other categories. So we just had a good year all the way around across all categories.

Operator

Our last question comes from the line of Susan Anderson with B. Riley.

Susan Kay Anderson - *B. Riley FBR, Inc., Research Division - Analyst*

I was wondering if you could maybe elaborate a little bit more on what you have in the pipeline this year in terms of automation in operations and technology. And are you expecting to get more efficiencies this year versus last? And should we think of it like a rollout throughout the year?

Julie Wainwright - *The RealReal, Inc. - Founder, President, CEO & Chairperson*

I'll start, and Matt can pick up. Look, it's -- the model's built in efficiencies more versus last year. There's a lot going on, a lot of moving parts. So I would say, we can -- it's better just to say that we expect continued efficiencies in our operation. And as you've seen, technologies played a part, not just our media buying, for reducing our BAC. So the combination are actually working hand in glove, and we expect it to continue. At some point, it's going to stabilize, but not this year. I think that's a fair statement. Do you want to elaborate?

Matthew Gustke - *The RealReal, Inc. - CFO & Treasurer*

No. Yes. I'll add a little bit more specifically. So -- in the areas of photo retouching and in copywriting, you should expect to see steady increases in penetration as a percent of our unit volume throughout the year. And then in our fulfillment operations, not so much automation. There's a little bit there. But the application of technology in process, we expect to see steady improvements in efficiencies -- in our operating efficiencies there as well. And with growth of the business, we'd expect to see some pretty decent fixed expense leverage, allowing for overall leverage of the ops and tech line on a full year basis.

Susan Kay Anderson - *B. Riley FBR, Inc., Research Division - Analyst*

Got it. And then just curious with, I guess, the introduction of some new technology for authentication out there available for consumers and even maybe consignment shops. I'm just curious like what you think about -- how you think about your competitive advantage in terms of authentication and kind of as you automate that process also?

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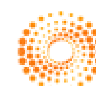

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Julie Wainwright - *The RealReal, Inc. - Founder, President, CEO & Chairperson*

So a couple of things. First of all, we operate in a really big space. Secondarily, no one's focusing on luxury, including Nordstrom. They're actually focusing on contemporary. And thirdly, we've looked at -- there's a product out there that's been cited in the press, that's been around for about 10 years. We constantly talk to that company. It's as good as the database that they have, and our database is bigger than anyone. So we're sort of light years ahead of everyone on this level, but that doesn't mean we're not looking at outside solutions on a regular basis to make sure that we -- if there's a better solution outside, we then play it. We're not a not-invented-here company. It's just every time we look at it, we're faster, better and more thorough than what else is out there.

We do have a really exclusive relationship. We don't spend a lot of time talking about our fine jewelry and watch technology, but we have a long-term strategic relationship with the University of Arizona for gems, and they are the premier gemology school in the U.S., where we can actually measure the depth of diamonds very, very accurately. And so the estimation that's being done in other auction houses. And that technology, we're also using it to identify the origin of those gems and different stones. And we think we can apply that in other really creative ways. So that's actually saved our gemologists a lot of time. It's made accuracy rate go up beyond an estimation. And secondarily, we think it has application beyond just gem, and -- because it does get into origins and metal types. So we're excited about that.

Operator

And now I'd like to turn the conference back over to CEO, Julie Wainwright, for closing remarks.

Julie Wainwright - *The RealReal, Inc. - Founder, President, CEO & Chairperson*

All right. So thank you very much for dialing in. We had a great year last year. Certainly, we're not resting on our laurels. We're going to have a great year this coming year. If any of you are in the Bay Area, San Francisco, specifically, after mid-March, we'd invite you to visit our brick-and-mortar store, which will open on Post Street, with also a door in the Maiden Lane. So please stop by. We'd love to see you there, and again, thanks for dialing in today and asking the questions.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating, and you may now disconnect.

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