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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the RealReal Fourth Quarter 2020 Financial Results Conference Call. (Operator Instructions)

I would now like to turn the conference over to your host, Head of Investor Relations, Mr. Paul Bieber. Please go ahead.

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

Thank you, Kris. Good afternoon, and welcome to the RealReal's earnings call for the quarter ended December 31, 2020. I'm Paul Bieber, Head of Investor Relations at the RealReal. Joining me today to discuss our results are Founder and CEO, Julie Wainwright; and Chief Financial Officer, Matt Gustke. Hopefully, you've had a chance to read our press release and stockholder letter that we distributed earlier today, both of which are also available on our Investor Relations website.

Before we begin, I'd like to remind you that we will make forward-looking statements during the course of this call. These forward-looking statements involve known and unknown risks, and uncertainties, and our actual results could differ materially. You can find more information about these risks, uncertainties and other factors that could affect our operating results in our most recent periodic report on Form 10-K, subsequent quarterly reports on Form 10-Q and in our earnings release from earlier today.

In addition, our presentation will include certain non-GAAP financial measures, for which we have provided reconciliations to the most comparable GAAP measures in our earnings press release. With that, I'll hand the call over to Julie for introductory remarks and then we'll go straight to Q&A. Julie?

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

Thanks, Paul, and good afternoon, and thank you all for joining us today to discuss our Q4 2020 results. Obviously, 2020 was a very challenging year but we were resilient and found ways to innovate. We are seeing encouraging signs of recovery, with December GMV back to growth and quarter-to-date trends even stronger. Overall, we are well positioned to emerge a stronger company.

We are tremendously thankful to our employees for their dedication during these unprecedented times. We especially like to recognize the teams on the front lines in our authentication centers and retail locations. Thank you for your tireless work and commitment.

We believe that as we come out of COVID, the tailwinds that have driven the outperformance of many of the e-commerce companies will slow. In contrast, we could see an increasing tailwind as major markets return to normal, which could drive acceleration in our business. This growth would help us realize efficiencies in our operations, leverage across our cost structure as we march toward profitability.

Last year, we embarked on several strategic initiatives that will position us to capitalize on the large opportunity ahead. The most significant initiatives include neighborhood stores. We plan to operate -- to open approximately 10 of these by the end of Q2. Given our early results, we're optimistic this strategy will allow us to further engage with our most valuable customers and significantly unlock supply more efficiently than marketing efforts alone.

Our vendor program is number two. This has improved our ability to source high-value supply, and we continue -- we will continue to invest in people, processes and technology to support its growth. The Q4 vendor channel GMV increased 80% year-on-year, our third consecutive quarter of acceleration.

Lastly, our Arizona authentication center. We accelerated the time line for opening our new facility to the summer of 2021 to support our next phase of growth. It will help us improve shipping times while reducing shipping expenses and fixed cost per order as we scale.

When we provided our last update in December, November supply and new buyer growth were trending positively and our GMV was gradually recovering. This recovery continued over the balance of Q4, with December GMV growth accelerating to 6% year-on-year. Our GMV trends have continued to strengthen so far in Q1 of 2021. Quarter-to-date through February 19, GMV growth was 14% year-on-year against a non-COVID period. Consequently, we anticipate full quarter GMV will increase between 17% to 20% year-on-year as we began to lap COVID impacts.

We are optimistic about our recovery in 2021. However, the reality is the pandemic is not yet behind us, which makes it difficult for us to provide a longer-term GMV outlook at this time.

The thought I want to leave you with is that we're excited about '20 -- that as we exited 2020, we were back to growth and we're excited about continuing our growth and supply momentum increasing in 2021, and this is underscored by widespread vaccine distribution, which is apparently around the corner. Hopefully, you've had a chance to read our stockholder letter, which contains a lot more details on our Q4 and early 2021 performance. So with that, operator, let's open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Oliver Chen from Cowen.

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

Regarding supply, what do you see ahead for the New York, L.A. markets? You did a really great job with growing supply in the other markets, and also you're managing a lot of innovation in the B2B vendor program. But what should be on our mind for Q1 and beyond with supply gathering and how the different regional pieces may mix?

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

I'll take this one. Right now, we're not going to make a prediction by region, but overall, we expect our supply continue to grow. And that really is -- it was already double digits for -- going into this quarter and supply growth, and that will be aided by our new retail neighborhood stores and vendor. So we feel as if we've reached a turning point on our supply coming in. We're very excited about the fact that we're now in the third month of growth.

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

Okay. And you had encouraging commentary on women's apparel returning to growth. Would love your thoughts on what that means. And if that may or may not be volatile and how the customer is behaving. And the really encouraging growth in new buyers, what's the data saying for new buyer retention and new buyer behavior on the platform?

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

So a lot of questions in there is normal. Number one, apparel is returning to growth. We expect it to continue to actually grow, given lockdowns are easing so we expect that to continue to grow and it's exciting. It's the first time women's apparel has grown for us since we had the lockdowns.

As we stated previously, we are -- well, our average unit selling price has really been driven by our high handbag sales and fine jewelry and watches. So right now, our AOVs are up, our ASPs are up. Overall, the ASPs are up. And it appears that our new buyers are behaving like our old new buyers did pre-COVID, but they're spending a little bit more money. In terms of their repeat rate back to the site, they look pretty similar at this point.

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

Yes, that's helpful. Last one, neighborhood stores sounds really innovative and you have good reads from the newest ones. Why was now the right time for that in this dynamic environment we're facing, where physical retail is really having to change quickly?

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

There are so many reasons why we know this is the right way to go. Number one, we had 1 test case in Madison, which has done phenomenally well, even with the ability to have limited capacity in the store during the COVID time. Number two, the rents in the neighborhoods have dropped precipitously and the willingness of landlords to do shorter-term leases, also critical to our decision-making. And number three, as you know, we are always looking to remove friction from the process for the consignors.

In a study we did about 6 months ago, this was a way that they also wanted to participate more neighborhood drop-offs. So the combination, sometimes the stars align, meant that it made sense for us to go ahead and open 10 as fast as possible. This year, with short-term leases with an eye to measuring both demand and supply, they are primarily for supply. And then we'll decide if we're going to open more. But right now, there are favorable terms for driving those smaller neighborhood stores to faster profitability than there were before COVID.

Operator

Your next question comes from Eric Sheridan of UBS.

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

Maybe I could touch upon some of the initiatives you had with the brands, harkening back to some of the announcements that you made last year. Obviously, one of the big goals you've talked about as a company is sustainability and going after some of the broader goals the industry is trying to also accomplish around making sure luxury continues along this path in forward years in the role you play. Can you talk a little bit as we update turning out of '20 and into '21 about the relationships with the brands and then more importantly, how it feeds into some of the sustainability narrative you've talked about the company?

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

Sure. I mean, as you know, we have Stella McCartney that's a long-term partner, then the first 1 to join in and actually has been always echoing the importance of the circular economy and its role in a more sustainable supply chain and fashion world. And Burberry is still with us. Gucci, we're still in discussions with. Gucci's relationships with the RealReal was different than any other prior relationship because not only did they encourage people to participate in the circular economy via consigning, they also encouraged them to buy.

So we are -- Stella and Burberry continuing. We're in conversations with Gucci, and there will be more partnerships announced later in the year. And it will be along the lines of reinforcing sustainability. So slowly but surely, we're about ready to celebrate our 10-year birthday this year. Slowly but surely, the message is coming through. And the time is right for this.

I also think that with the administration shift in the U.S., I do think there's going to be a greater emphasis on environmental impact of each industry. And I don't think that's lost in the brands that we are working with the RealReal and other people that do resell make sense in order to hit -- have them hit their own sustainability numbers.

Operator

Your next question comes from Michael Binetti of Crédit Suisse.

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

Thanks for all the detail in the shareholder letter today. I guess can you speak to the first quarter GMV guidance? I don't mean to be short term, but 17% to 20% GMV growth with 14% in the quarter-to-date, and then obviously, March gets about 45 points easier just based on the monthly reporting you provided. So is there -- I'm wondering if there's something in the flow of supply that would cause the multiyear to slow? Or is it just an abundance of caution on your part until we go around the bend here. I'll start there and I have a follow-up.

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

Yes. So like everything with GMV, it always starts with supply. Supply has been doing well, been building progressively. We're happy with how that's trending. And you're right, but if you check -- track the progress, December was our first month of getting back to positive growth at plus 6%, quarter-to-date, 14%, which, of course, implies over the balance of the quarter, there's some acceleration.

Listen, we're still in the middle of COVID so there is an abundance of caution here. This is the first time we've been comfortable enough to put anything resembling guidance on paper. So I think coming out of the gate, this is a positive step forward in terms of we have some visibility but more importantly, increasing confidence in the trajectory of our recovery. So we're happy with it. And of course, we're going to look to overshoot.

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

Great. Okay. And then I guess, can you -- you mentioned in the shareholder letter some of the image recognition software is something that can help you on the inbound supply. I'd love to hear some thinking on that. We've seen some interesting stuff on that from competitors in this space. And then, Matt, if you wouldn't mind just walking me through, I just thought the back of the shareholder letter, you commented that gross profit per order in the first quarter, I think, would be flat year-over-year, and I think that was down a bit in fourth quarter. So maybe just what was driving that in the fourth quarter? And what's different in the mix in the first quarter, please?

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

I'll take the first part and then Matt can take the back. We've made tremendous progress in automating our op centers but it wasn't just image recognition but recognition played a part in it. It's really machine learning and computer vision, along with some image recognition. So now in copywriting, price automation, photo editing, in particular, we're up to about almost 80% in all of those of automation, which means that the people we employ are doing more QC work and QA work. So we continue to accelerate there.

We also have, unlike most of the people in this business, we also have a huge fine jewelry and watch component, so we've been able to further our automation of measuring the depth of diamonds within the setting without having humans recalculate it twice in the old way, which we still do for all other types of stones because we would never remove the stone from a jewelry. So our automation continues fairly regularly and a little ahead of schedule in our op centers, which is actually, to be honest, that is where we've been focusing, but that technology can be applied across multiple channels later on. I would just say we're really pleased with the progress. And these are the key things we needed to feel comfortable to support our growth and decrease our unit economics in our op centers.

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

Yes. And I'll take the second one on the overview on gross profit drivers. So you're right, we are comfortable to guide to flat gross profit per order in the first quarter. Dynamics underneath there: one, as always, growth drives leverage all throughout the P&L so that's helpful. We have been seeing, to Julie's earlier comments, improvements in our average order value, driven by good contributions from high-value categories. We're also seeing nice year-over-year improvements in our shipping expenses, so all adding up to the good things kind of offsetting the little bit of work we have left to do recovery on AOV and take rate, which continues to be correlated with those high-value products.

Going back to Q4, a little bit of that as well. So AOV, first, was down 6% year-over-year, almost exclusively due to units per transaction yet to climb back to historical norms. In addition, we had a few other things going on. Take rate was down 50 basis points year-over-year due to the strong performance from high ASP categories, handbags and jewelry, in particular, as well as more consignors earning higher take rates. That means a higher contribution from our existing repeat consignors.

Second, we did see elevated levels of buyer incentives in Q4. We use buyer incentives as a tactic to garner both new buyers and consignors. And it has had an immediate impact and it's really just kind of a shift out of traditional marketing to be -- to more immediate impact. So we use it as a way to stimulate buyer and consignor activity during COVID, but as our growth recovers and supply growth, in particular, recovers, we expect to see that decrease over time. And then finally, there was a $2.2 million onetime adjustment in Q4 that's described in detail in the stockholder letter.

Operator

Your next question comes from Erinn Murphy of Piper Sandler.

Erinn Elisabeth Murphy - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

Nice to see the recovering growth. Julie, I guess my question for you is on the 30% of new consignors that are coming from stores, I think that was just for the month of December. Can you share a little bit more about what you're learning about this new consignor versus maybe other new cohorts in the past? And then a follow-up for Matt, on the new DC in Arizona, can you just talk about how new -- or how shipping times, excuse me, will look when you're up and running there? And then your plans for the Brisbane DC once that -- once Arizona is up?

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

So well, first of all, we are excited about our new neighborhood stores, obviously, since we've committed to opening 10 in the first 6 months and that's based on some early results. Now all of this data is rather preliminary outside the Madison store. But the consignors who actually consign at a retail location tend to consign 1.5x more in value than consignors that consign to other venues for us. They also tend to have a higher NPS score.

So early days on that for the retail stores but we're pretty excited about the early results. The interesting thing right now, these results are based on a limited capacity constraint that we have in our stores due to COVID. So when you look at, given all the constraints that are put on our business, including, for example, in Palo Alto, we could only have 4 people in the store at one time beyond the sales team. It shows that there's a pent-up demand for a frictionless consignment in a neighborhood. So we're excited about our early results look very promising.

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

Yes, just a little bit more detail on Arizona. So this is purely about us focusing on the next phase of growth. This is our largest facility in our portfolio and should set us up for a few, if not, several years' worth of growth. In terms of shipping, right now, it's not -- like in the early days, it's not going to be much of a difference because we do have some capacity in both coasts to sort of load balance. But as we continue to grow, we would max out our capacity here in Brisbane and then have to start shipping things larger distances.

So it's really as we start to grow, it allows us to keep optimizing our shipping distances, costs and managing service levels to customers and consignors, by the way, in terms of products coming in. So we're really excited about this to give us the capacity to grow over the next several years and by a wide margin is our lowest cost location. So it's going to drive a lot of expense leverage as we scale on a fixed cost per order basis.

Erinn Elisabeth Murphy - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

Got it. And if I could just add a follow-up, Matt, for you on the shipping contracts that you negotiated at the end of '19. I know on this call last year, you talked about originally planning 500 basis points of gross margin improvement. Then obviously, COVID hit. So curious, if you look forward into this year, GMV is clearly accelerating. How do you think about kind of the gross margin opportunity once we -- now that we're seeing that top line inflect from specifically the shipping contract renegotiation?

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

Yes, yes. So the shipping contract itself is doing what it's supposed to do. So as we get growth back, we're going to get all of the leverage that we anticipated out of shipping. Gross margin itself is a bit of a tricky number for us because we have this mix of direct and consignment revenues with inherently different gross margin profiles. So that's sort of the unknown. But we actually think that the direct revenue mix will increase somewhat as we lean into the vendor opportunity, including selectively purchasing inventory upfront, which we have seen is yielding higher prices and better margin profiles for us.

So to the extent that we continue to see that happening, we're going to keep doing that. So that's going to keep mixing direct up. So hence, we just keep trying to encourage people to focus back on gross profit per order as the metric to track how we're progressing in our overall productivity and path to profitability. And we see the opportunity to get from the roughly $80 level that we were at most recently to about $100 -- nearly $100 in the next 12 to 18 months.

Operator

Your next question comes from Edward Yruma of KeyBanc Capital Markets.

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

I guess, first, trying to understand a little bit on the supply side promotions you've been running. It seems like some of your competitors are kind of driving take rate down in an effort to jump-start their businesses. Just kind of stepping back, do you think there's been any impact? Or do you think that this is a period of kind of pronounced promotions on that side?

And then second, with Arizona plus neighborhood stores, is there something we should think about from like a near- to medium-term expense build perspective? And then just kind of one final question. On the vendor relationships, I guess any sense as to whether that is negative to the relationships that you've been so successful at building with the brands?

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

All right. I want to -- this is Julie. I'm going to take some and turn it over to Matt. So let's just talk about the last one first. The vendor relationship, some of the vendor relationships we've been building with the brands are the same brands that are working with us in other capacity. So actually, to me, they work hand-in-glove, and our vendors are a little more diverse than just the luxury brands that deal in fashion because we do have other categories with fine jewelry and art and home that we also source from. And those have been -- especially the art and home vendors have been very good for us during COVID times, but we do have a variety of vendors that are in the fashion world.

But some of the vendors that we work with strategically are also vendors that we work with on our vendor side of the business for overstock or other types of products. Sometimes they're running tests. So that's what's going on with the vendor. Do you want to take the other?

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

Yes, yes. Kind of -- as I recall -- remember the question. I was gone for like half of the question...

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

Yes. A 3-part question.

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

Test our memory. So I think the second question is around -- just basically around store financials and what does that mean for the P&L and the balance sheet over the near term. The good news with these stores is that because they're small footprint with short-term leases and favorable environment for getting lease terms for retail right now, as you might imagine, these things aren't particularly expensive. So we think -- I don't want to be overly precise here because we don't really have much data, but we're hopeful that these things can become sources of profit in the plus or minus a year from opening them, and they really don't take much capital to open. We get them open in 4 to 6 weeks after we sign a lease, spend $200,000, $300,000 in capital, right? So rolling out 10 of these is a handful of million dollars of capital this year.

And once we kind of get to the back end of this year, we start to get closer to tipping point where it becomes neutral to the P&L. In the short term, it's a bit of a drag but really not that much. And then I think the other question is around the take rate environment and pressure we're seeing.

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

We're not...

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

We're not seeing.

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

So look, what we've seen in the press with the take rate is that it's sneakers and watches. And our watches' take rate has always been competitive within that space and the watch resell market has always been competitive. So that really hasn't put any damp on it. Our sneakers, it's not a big component of our mix. We're still getting amazingly high-quality sneakers without changing our take rates.

So this is the beauty of being a multi-category, multi-brand business where if someone decides to bring the take rate down to 0 for sneakers, really doesn't impact us. Our take rate shift in our P&L is mostly due to us selling more high-value things because during COVID, in particular, it was handbags and fine jewelry and then watches, in that order, and then men's. And so those first 3 already have what we would consider a really good competitive take rate that didn't change. They -- now we're adding apparel this quarter. Apparel is coming back to life and selling, so that will change the gross margin again in terms of percentage more on the positive side.

Operator

Your next question comes from Justin Post of Bank of America.

Justin Post - *BofA Securities, Research Division - MD*

Two. I guess the first, can you, maybe Julie, compare the vendor program economics to the core-sourced inventory? Any big differences we should be aware of? And then the second one is for Matt. Maybe you could help us just -- I know you did incentives in Q4, buyer incentives, extra marketing, which makes sense. Help us think about how to frame an EBITDA outlook for the first quarter.

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

So vendor economics overall are good, but it is a supply that -- in fact, it's net accretive to the business. However, it's not -- we still have to be very careful on the supply. And our goal is not to become Overstock.com where, in fact, you would end up dropping prices on quite a few. So our approach to vendor is we wanted to increase our diversity of supply vendors that really sort of one that is there for the taking. We can have a good gross margin on it with a high price, but it doesn't mean it's a free for all in the way we take in our products.

So -- and we also do have to invest in that platform, meaning getting a SKU depth on our platform to really optimize that along with invest in the team. But it is -- the unit economics are good on vendor. The core stores, again, too early to call. They look pretty amazing. They have an added benefit of both getting supply for us and we do sell things there, and we tend to sell things at a much higher AOV, which is accretive to the average overall AOV, which makes sense. If you think about it, high-value things sell faster in person than perhaps they do online.

So -- and they also have a marketing benefit. So those transcend just supply acquisition, and we've got a lot of analysis to do on those as we get out of COVID to see how high is up with them, but even in COVID times, they look good for us.

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

Yes. One quick thing to add on vendor economics. It's important to keep in mind that vendor and buying upfront or taking inventory are not synonymous. The majority of our vendor business comes in on regular consignment terms just like everybody else. It's more about how it flexes our supply in the direction we want it. So we can be more strategic about adding high-value supply.

There is, of course, some direct inventory purchases there but there is on the consignment side as well. So those are really 2 separate vectors. The focus of the vendor channel is to bring in incremental, high-value supply and enrich our gross profit per order metric overall.

On the other question around bottom line expectations for Q1. So obviously, we're too much of a period of uncertainty for immediate comfortable to be declarative about that. But we've done what we could and provided the transparency that we think is appropriate in terms of GMV, seeing GMV acceleration, gross profit per order being roughly flat and directional guidance on our operating expenses, namely: marketing, which excludes the buyer incentives, being down modestly quarter-over-quarter. Our ops and tech up substantially quarter-over-quarter as we start realizing expenses in Arizona. We open a bunch of these core stores. We're investing in technology to support all of the above. So that one is going to be up a decent amount. And then SG&A, as we said, kind of just up very, very modestly.

So add it all together, growth -- the extent to which we grow is going to be the real determinant of where the ultimate bottom line sort of shakes out. But there's still a fair amount of range that, that could be.

I didn't mention -- I did -- buyer incentive, I guess, the answer to that is essentially embedded in the guidance of gross profit per order being flat year-over-year, meaning we already see that, that's going to start trending down hand-in-hand with our supply recovering, now back to positive available inventory on a year-over-year basis. We hit that in January. So as we continue to grow supply, it just lessens our dependence on using those types of incentives. So we are seeing that.

Operator

Your next question comes from Mark Altschwager of Baird.

Mark R. Altschwager - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Was hoping you could give us an update on the trends you're seeing with the virtual appointments. How are some of your larger white-glove clients adapting to this now that we're all getting a bit more used to the virtual interactions? And also curious how the sales team productivity is trending with the move to virtual.

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

So we look at multiple channels. And when you look at the ones that have some sales involvement we've got, we still have a little bit of in-home. We've got virtual. We have ship direct where people put it in a box and ship it directly to us and now we have stores. And I would say virtual is closer to the stores than the previous white-glove, and we're starting to go back into people's home upon request.

So for example, if we go into your home, we tend to pick up maybe 50% more items than if we actually do a virtual appointment. So the productivity is almost breakeven and early days. Having said that, we think once we get out of COVID, that virtual will get more productive because we'll get our -- it's just going to be a mix between white glove and virtual, depending on where people are. So the efficiencies have been -- almost, it's a wash but it's still a good tool. It's a great tool for us to have during COVID times.

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

Yes. And like longer term, we don't -- we don't know what the mix is going to look like, but we're going to let our consignors lead us. And whatever they feel is the least amount of friction for them, we're going to do it. So in-home definitely has a role. Virtual does have a role but how it ultimately shakes out remains to be seen.

Mark R. Altschwager - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

And then Matt, just a quick follow-up on some of the vendor-related commentary. Inventory looks like it was up pretty significantly year-over-year. Can you maybe just give us a bit more color on what's going on there, the drivers and any implications as we look ahead?

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

Yes. Our inventory is sort of a law of small numbers here, so it's like up in a percentage basis pretty substantially year-over-year. I think it was 70-something percent increase. But that's still only in the few tens of millions. The majority of that increase relates to a couple of large vendor transactions that we executed in the fourth quarter. And so far, we really like what we're seeing in terms of average selling price, the product margin that we're realizing and how quickly things are selling. So slight small term use of cash for what we think is going to be additive to gross profit per order and ultimately flushing through the P&L as we go forward.

Operator

Your next question comes from Ike Boruchow of Wells Fargo.

Irwin Bernard Boruchow - *Wells Fargo Securities, LLC, Research Division - MD and Senior Specialty Retail Analyst*

Let me add my congrats on the acceleration in the business. Matt, 2 questions for you. Just first quick one on vendor direct. I think last quarter, you had said it was going to be around 10% of the business, and it could get to 15% to 20% over the next 18 months. Is that kind of the way we should think about the upcoming fiscal year in terms of penetration?

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

Okay. So let me disaggregate this again. So vendor, the channel we call vendor, which is business sellers, combined on a consignment basis on an inventory purchase basis, in aggregate, yes, I think we'd still say that tracking to 15% to 20% of total GMV is the right zone for that, sort of progressively as we go through the year. The opportunity there is still quite substantial. There's still a lot of inbound interest, and we'll continue to see very strong growth there.

Irwin Bernard Boruchow - *Wells Fargo Securities, LLC, Research Division - MD and Senior Specialty Retail Analyst*

Got it. And then second question, Matt, just bigger picture. So on profitability, adjusted EBITDA, positive outlook, I totally understand it's not clear right now. But I guess the higher-level question I wanted to ask you would be, I believe pre-COVID that the Street was kind of expecting you to hit that mark around a little over $2 billion of GMV. I guess just the high-level question I have for you is, has the model evolved over the past 12 months so much so that revenue or GMV number would change, meaning maybe you would need more GMV because of incremental cost in the business or greater mix of lower-margin revenue or maybe it's come down because of better efficiencies in the model? I'm just -- at a high level, I know you don't want to get into the details, but just holistically, how would you kind of think about that?

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

You're right. I don't want to get into the details on something that's out that far. So obviously, the further we go out, the fuzzier things become. But sitting here, I'm not going to update anything that we may have talked about in the past. But fundamentally, there's a lot of good that's come during COVID. And the thing that I think I'm most encouraged by is having a more diverse set of supply channels that allows us to be more predictable in how we grow the business going forward and coming out of COVID as well as the progress we've made in other areas.

So at the very highest level, sitting here and looking out that far into the future, I really don't see anything that's a fundamental setback in terms of when ultimately we're going to hit that point of breakeven. Now in between now and there, of course, a lot of things can happen. If we really love what we're seeing from the neighborhood stores, and we say, "Hey, we're going to do a lot more of those," they'll continue to be a short-term drag. But we'll balance that, as we always have done, in making sure we're getting the right amount of investment, we're focus on -- focusing on profitable growth going forward.

Operator

Your next question comes from Simeon Siegel of BMO Capital Markets.

Simeon Avram Siegel - *BMO Capital Markets Equity Research - Analyst*

Matt, sorry if I missed it. Could you elaborate on what drove the buyer incentive contra rev items this quarter and that $2.2 million reconciliation adjustment? And then just any help, just given the moving pieces, any help on how you're thinking about returns and cancellations for Q1 and then whatever comfort you have into this year?

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

Okay, another 3-parter. I think I got a returns adjustment and buyer incentives. Buyer incentives, just think of like -- think of them as sort of like couponing that are specific to individual buyers or consignors. And we've historically used that as a tactic to drive GMV and supply, new buyer growth, new consignor growth. It tends to run about 1.5 points, maybe 2 percentage points of GMV. In the fourth quarter, that got up closer to about 3%.

As we were -- we're encouraged with the trends we are seeing. We really wanted to drive it. It's more of an immediate call to action than broad-based marketing. So we're seeing good results from it. So on a short-term basis, we pivoted some of our marketing investments into buyer incentives. Don't expect that to be the case on a sustained basis because supply is really what is the big governor of how much we need to lean into that or not. So it's really a short-term tactical thing.

Returns and cancels continuing to be favorable versus where they were but roughly flat on a quarter-over-quarter basis is how I'd be modeling it. We are going to see a reversion to the mean over time as we sort of come through COVID and product mix really starts to kind of come back to where it was. So it's almost sort of a U-shaped recovery, I guess, or just kind of reverting to the mean.

And then the adjustment. So as part of our audit in 2020, we discovered and corrected an immaterial error that had been accumulating little by little over time. The error itself related to a subset of consignor payments that were made manually outside of our normal payment processes. And some of these manual payments were incorrectly recorded in our financial statements. We have corrected the reconciliation process, so that's good news going forward. And we're going to flush the adjustment back to the period that it belongs in when we present our quarterly results with the filing of our 10-K.

So again, immaterial, onetime adjustment and really no meaningful impact on our go-forward financial results. And for clarity and hopefully, helpfulness in the stockholder letter, we presented Q4 both with and without this. So it doesn't sort of muddy the picture on a year-over-year basis.

Operator

Your next question comes from Aaron Kessler of Raymond James.

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

Just a couple of follow-up questions. Maybe just on the operations and tech. I realize that in kind of the first half, it sounds like that's going to be increasing at a healthy amount. Should we start to expect some leverage in that line as we go into the second half of '21 and then into '22, obviously assuming kind of GMV ramps throughout the year as well? And then just maybe on the vendor impact on take rates, can you just give us a sense for that? I assume you're managing more to a gross profit per order but just maybe just the impact on take rates as well would be helpful.

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

Okay. Let me -- vendor impact on take rates. Somebody remind me of the first question.

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

Ops and tech leverage.

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

Ops and tech leverage, all right. Thank you. Well, vendor impact on take rate, overall, it should be pretty modest because the -- again, what I can't predict is the mix between consignment and direct purchasing. Let's just move out of the equation for now. On a like-for-like basis, all things equal, it's virtually identical to an individual consignor. The main difference is the mix of products that are coming into that channel.

It tends to be, and on purpose, it is skewed more toward higher-value products. And those inherently, structurally, in our commission structure, have lower take rates. But overall, it's not going to really have a significant impact, net-net positive in terms of gross profit per order the -- whatever we give up in take rate is more than offset by higher AOVs and ultimately, gross profit.

In terms of ops and tech, I don't want to get too precise because I don't know. So the investments that we're making in the short term, core stores, we kind of laid out what that looks like overall. Technology is -- we'll continue to invest alongside the growth in the business and to power a lot of these strategic initiatives, the vendor program, retail, Arizona, et cetera. And on a short-term basis, yes, that's an increase.

When it delivers leverage, that's tougher to say, so it's really what does our growth profile look like as we come out of COVID. The OpEx part is obviously more controllable. But to the extent that we kind of start lapping COVID, we see very strong growth rates. And fundamentally, the business is sort of in a steadier state of recovery. I would expect to see progressive operating leverage each quarter as we get through the year.

Operator

Your next question comes from Susan Anderson of B. Riley.

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

I guess a quick follow-up on the neighborhood stores, and I'm just curious if there's any insight you could give into how much it cost to open them and then also the time frame to profitability. And then if you're looking at specific cities or regions where you're planning on opening them?

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

Do you want to? Go ahead.

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

Sure, I'll start. And we talked a little bit about this earlier on. We'll have about 10 of them open by the end of the second quarter. They range in footprint from a little over 2,000 square feet to a little bit more than 4,000. Brooklyn is on the higher end of that spectrum, a little bit larger in that 4,000 neighborhood. But generally speaking, we're looking at 2,500 square feet, 2-, 3-year lease terms, about $300,000, call it, in CapEx to get it open, it takes us 6 weeks to open.

And then we're hopeful -- we don't know because like our oldest ones are just a few months old, but we're hopeful that the -- on a 4-wall basis, these things can look like approximating breakeven in about a 12-month basis. So in the short term, it's a drag, right? But like then as we -- then we let it go and they continue to perform, then this time next year, they should be extra source of leverage.

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

Right, they should be. And we did model it based on continuing to have restrictions in the store with a number of people based on some COVID restrictions. The location was the other thing you were talking about. Again, this is going to be no surprise. Think of neighborhoods outside key urban areas. So for example, we opened Palo Alto. We opened Brooklyn. We may open another 1 in New York City right now. We only have 2, and New York is a big place and people don't like to leave their neighborhoods. So you start thinking of Connecticut as sort of a natural place, other places in California. We opened Newport Beach. And yet we have a store in West Hollywood.

So it's sort of you can almost figure it out yourself by assuming here's the big cities in the U.S. and here's radius where there's huge pockets of people that most likely aren't going to travel that far to either buy consignment or drop off consignment but would prefer a neighborhood store.

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

Great, that's helpful. That makes sense. And then I guess just a follow-up on the trends that you're seeing by product category end of February. Are you expecting, I guess, apparel to continue to increase and maybe, I guess, shift back to pre-COVID levels? Or should we think about first quarter being similar to fourth quarter in terms of the penetration of jewelry and handbags?

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

So already, it's shifting. So I don't -- we don't know, obviously, what's going to happen, but everything besides kids and beauty is growing at a nice clip. So every category is growing without diminishing the jewelry and handbags and watches. So we're actually having nice growth across everything. The nice -- the bulk of our business is in women's apparel. So it was good -- once that returns to growth and it is comping a non-COVID month right now and we're non-COVID 2 months, it looks -- it gives us a lot of hope.

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

Yes, that's definitely very positive. Good luck next quarter.

Operator

Your next question comes from Marvin Fong of BTIG.

Marvin Milton Fong - *BTIG, LLC, Research Division - Director & E-commerce Analyst*

Just on the neighborhood stores, a follow-up question on that one has been it looks already tremendously successful. I think if we go back to some of the statements you've made in the past, Matt, that maybe you get to like 10 or 12 stores or so. So is the second quarter going to kind of round out your store opening plan for that? Or do you see, with the success you've been enjoying, that maybe you could increase the number of stores, ultimately?

And then I think you had also said in the past, it would be primarily drop off points and not points of where there'll be a lot of retail activity. Just curious if your -- what you're seeing is maybe making you rethink that. And then just one last question on international, something we really haven't talked about a lot because of COVID and which you've had to do strategically to stabilize the business. Just curious if you think international is something that you can make some progress in FY '21.

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

Okay, Matt?

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

Okay.

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

3-parters.

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

4-parters. So neighborhood stores, I think that the question around roughly 10 stores, I hope that's not where we stop, right? So if in the stores that we open look like the ones that we've opened recently in Palo Alto, in Brooklyn, in Newport Beach, and those 3 continue to perform like they have or better, frankly, as capacity restrictions get loosened, we're going to probably want to open up a fair number more of them because they look like they can be substantially more efficient at acquiring and unlocking supply than our marketing investments alone. Far more targeted, far more personalized, local, it's what consignors want to do. So I would not be shocked. I would actually be quite pleased if 2 quarters from now, you're talking about a more aggressive rollout of these stores. That would be a fundamentally healthy thing for our business.

In terms of our view on how the mix of supply versus demand, still, I think we look at them as -- from an incrementality perspective, they're most powerful on the supply side. They acquire new consignors very efficiently and bring a lot of incremental supply to us. On the demand side, you can argue -- like they're helpful, yes, but it makes it easier to sell high-value products. The return rates are exceptionally low, buyers love it. I mean our NPS in the store is quite high. People who interact with our stores are far more active on both supply and demand than people who only do interact with us online. So very healthy. I think it's a good question because I think we're finding that there is a lot of interest in people shopping in the stores. And there's like, across the board, see very good sales, not just supply.

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

Well, wait, but they are a smaller footprint. So if you just look at the sheer number of SKUs we have in the store, and they're smaller footprint by design, which means they get their -- they're just the cost efficiency supports smaller footprint versus flagship. But they have about 1/3 of the SKUs or less of what a flagship store would have. So by its nature, it's up to the merchandising team. They've done a really good job of fine-tuning that mix to maximize the dollars even in sales per square foot based on the local neighborhood.

So that's -- which means they are -- we've never said, you can't buy anything. It's just the size alone dictates a certain level of success because they will, just by their size, restraints have less SKUs.

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

You want to take the one, international?

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

International. We have international in our crosshairs. I do not expect to see any impact from it this year, but I would assume that planning will begin for a launch next year or sometime this year.

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

Planning this year for a launch next year.

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

Right. So said another way, do not expect to see incremental expenses or incremental GMV associated with international this year.

So back to me. I want to thank you for your attention. I want to encourage you all to get vaccinations when your time comes up. And just leave you on the note, we're excited to be back to growth, and we're looking forward to our next call for our Q1 results. Thank you very much.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day. You may all disconnect.
