From Underdog to Pet-Favorite: Chewy's Journey

Michael Kravshik: [00:00:00] Welcome to LumiQ. I'm your host, Michael Kravshik, and I'm here with Larry Cheng, Founding Partner at Volition Capital. Larry, thanks for being here.

Larry Cheng: Thanks for having me, Michael, I appreciate it.

Michael Kravshik: Yeah. Well, today we are talking about Chewy and no, unfortunately not Chewbacca, but about a company that supports our non fictional furry friends instead. For those unfamiliar, Chewy is a pet food delivery startup that was acquired for 3.35 billion in 2017, which at the time was the largest ecommerce acquisition in history. And Larry, you were their earliest investor and you played a very involved role all the way up to the acquisition. And so the outcome for Chewy was obviously incredible, but that's not what's most interesting about this business case. Chewy made a number of decisions that let's just say were not the obvious ones to make along their journey. And so a lot of our discussion today is going to focus on these strategic [00:01:00] decisions walking through the options, the factors they considered, and of course, how it all turned out. So we'll walk through the story chronologically so that everybody listening is going to have some of that context around these decisions. And of course, we're really lucky to have you here, Larry, since you bring that detailed look behind the curtain that we really couldn't get anywhere else. So there's a ton for any business person to learn from Chewy's story, so I want to get right into it. But just before we do Larry, why don't you introduce yourself to our audience?

Larry Cheng: Sure. As you mentioned, I am the Managing Partner and Co-Founder at Volition Capital. I lead all of our internet and consumer investing, we are a growth equity firm based out in Boston. So I've been doing this in my career for 20 plus years and we launched Volition Capital back in 2010, and actually Chewy was an investment we made in 2013. So early on in the history of Volition that helped us to become where we are today.

Michael Kravshik: Let's go back to the beginning, I mean, Chewy was founded in 2011 by Ryan Cohen and Blake Day. I guess give our audience a little bit more of an introduction [00:02:00] to the company and their mission and certainly what they were thinking about in those really early days.

Larry Cheng: Yeah. So Ryan Cohen and Blake Day, they actually didn't know each other. They both dropped out of college, they met on an IRC chat room. They decided to do affiliate marketing together where they were selling things online and taking a cut, you know, like the good old days. And then decided that wasn't going to last, so they wanted to start an econ business. And so they decided to start a jewelry online retailer and, you know, think back to the Blue Nile days and so they bought some jewelry as their starting inventory. And in the very early days of this process, Ryan actually went to his local pet food store called Mary's Pet Shop, and he's in South Florida, in Miami. And it was such a miserable experience, they didn't have the pet food that he wanted. So it was a really dingy store and he thought surely we could do better than this, and he decided to switch gears from selling jewelry to selling pet food. And sold all of the inventory that he bought on jewelry side and decided to [00:03:00] launch chewy.com. It was actually called mrchewy.com at the time. But I should say, the way the name came out was interesting, he went and stood outside of a Petco and he had two options Mr. Milo or Mr. Chewy were the two names. And he literally asked customers that leaving Petco, which one did you like better? And everyone liked Mr. Chewy. So that's what he started with, it became chewy.com and the company was born. I love that founder story of standing outside the store and asking random people questions. I've been there myself and I'm sure like 2/3rds of the people looked at him like he was crazy and just walked as quickly as possible the other way, so that's amazing.

Michael Kravshik: Just to give us a sense, how did they finance that those like early day before you and Volition got involved.

Larry Cheng: Yeah, so they had made some money from their affiliate marketing days. They were pretty good direct marketers and they took that money and they started a company and it's sort of interesting. In the early days of the business, they didn't actually have much inventory on hand because they didn't [00:04:00] have much money. So they would list products for sale that they didn't actually have. And if someone bought it, they would go back to the Petco or PetSmart, buy it at retail, then go to FedEx Kinko's and ship it at retail, and that's incredibly uneconomic way to do business. But that's what they did, they probably had a lot of gross margin sales at that point in time. Quite quickly, they built up some scale and were able to buy through more normalized wholesale means, but that's what it looked like in the early days.

Michael Kravshik: Well, and was that their thinking that like, okay, we're going to lose money on every order right now, but once we get to scale, we will be able to buy these at, you know, at a better discount, be able to drive the margin that way or was there something else going on?

Larry Cheng: I think you have to fake it till you make it. So I think that was the thinking that you can't have a pet food store online without product, but you could certainly couldn't afford to buy all the product. So they did have some product, but they didn't have it all. So that's how they filled in the gaps until they got to some scale. And in that 2011 timeframe, the company did about a [00:05:00] couple million in sales and then it started to get to more normalized distribution channels.

Michael Kravshik: Yeah. I mean, it's pretty wild that even in their first year, they got to. As you said, just under a couple of million in revenue and this is, I mean, how are they marketing at that point in time?

Larry Cheng: In the early days, they were doing all on direct online marketing through paid media, paid online channels. So that's what they were good at as affiliate marketers. So they would generally market around keywords around the specific products that they were, that they had. And obviously some products that they didn't have, and that's how they acquired customers. Actually not just in the early days, but for quite a while as this story unfolds that was the primary means.

Michael Kravshik: At this point by 2012, they actually decide they want to go raise some money. Can you help us understand? I know this was just before you got involved, but help us understand what was their thinking in terms of how much money they wanted to raise, what that money was for and what kind of investors they were going after originally.

Larry Cheng: Yeah. So they knew they couldn't self fund this business forever and fake it till they made [00:06:00] it. So they wanted to raise some capital and they didn't really know how neither of them had raised venture capital before. So what they did was rather unusual, they decided to go literally, physically to Silicon Valley. And they went to Sand Hill Road, which is where a lot of the old venture institutions are located. And Ryan literally walked the door to door different venture capital firms offices, and he would walk up to the receptionist. And basically asked to meet with the top partner that would possibly do an ecommerce investment. And if you know anything about raising capital, that's exactly not how you get a meeting with the top partner at a venture firm. But so he did that, and to no surprise, he didn't get any meetings with anybody. And he did a lot of outreach, and at one point he said that he had reached out to over a 100 VCs. And no one took them up on a call, no one visited them, no one met with them, and it was after that point in time where we come into the picture.

Michael Kravshik: Yeah. So tell us, like how did you a, like even hear about Chewy and what got you [00:07:00] interested enough that you decided to take the phone call?

Larry Cheng: Yeah, so we actually reached out to them. We at Volition have a direct outreach effort, where we're calling companies that we think might be growing. And there are different growth indicators we look for, like employee growth and website growth. And sometimes we have credit card data, we can see if companies are getting sales and so forth. We tend to not be afraid of models that other investors don't like, and I should put this as context. The reason all the VCs were passing was because in the dot-com burst of the 2000s, pets.com was the first pet food retailer, ecommerce retailer. And they were the abysmal failure of the dot-com burst, right? The sock puppet was the famous.

Michael Kravshik: Yeah.

Larry Cheng: It's the iconic failure of a time of excess, and the sock puppet has gone down in history as a for the image and the symbol of this failure. And so the idea that you could sell a 50 pound bag of dog food that cost 25 bucks and ship it online economically and make the math work like that was proven to not work for [00:08:00] pets.com. That's why no one wanted to meet with these guys, but we decided to meet with them, we had a first call back in November 6, 2012. And then I was intrigued, so I actually went down to meet with them in Miami on November 12th. So a week later, and at this point in time they were very scrappy, they were breaching 20 million of revenue, growing pretty aggressively. And I really realized that there was a change in the market, which is that pet owners were focused on premium pet food. It was called the theme of sort of humanization of pets, so that 50 pound bag of dog food that used to cost 25 bucks now cost 75 or a 100 bucks, and that math would change. And so I took note of this sort of young affiliate marketing oriented team, they were very customer obsessed. Ryan, I remember from that first meeting would read every single review from every customer. And if there were any issues, he went back to resolve it and look at it directly but I took note, I didn't jump at it. Right at this moment in time, that was going to happen later in the year, but that's why I took that first meeting, I thought they were [00:09:00] growing really aggressively and it was an interesting space.

Michael Kravshik: Well, yeah, I mean, you just dropped quickly there. They were approaching $20 million at some point in 2012 and they were at like two a year earlier. I mean, this isn't just fast growth, this is insane hyper growth, what was driving that?

Larry Cheng: So the value proposition that they had, which is very simple. You could get your food, your premium pet food, it's always in stock. You'll get it at a lower cost and you'll get it shipped really quickly to your door, and so it's cheaper and better service than your physical retail options like Petco and PetSmart. And this actually was something that I looked into when we got into the diligence phase is I would literally go to a Petco and a PetSmart and I did. And I would comparison shop with what price they were selling a particular pet food at versus Chewy. And the distinction was Chewy was generally 25 to maybe even 50% cheaper than Petco and PetSmart. And both of those companies, I looked quickly because I'm an investor. I looked at who owned [00:10:00] those businesses and they were owned by LBO firms, and so, and these companies had tremendous amounts of debt. And the last thing an LBO firm wants to do is squeeze their own margins by lowering pricing. So Chewy is coming in and saying, listen, you can get 25 to 50% off most products. You don't have to brave your traffic and parking, you don't have to brave inventory not being in stock and you'll get it the next day or two. And that's a really great value proposition, it's a no brainer and so that kind of got me intrigued with the business.

Michael Kravshik: Yeah. And just to be clear, LBO, you mean Leveraged Buy Out firms, and give us that small aside. Why would a leveraged buyout not be interested in, you know, the kind of strategy that Chewy was taking?

Larry Cheng: Low margin businesses require tremendous scale to start generating cash. And so they had a higher margin business in Petco and PetSmart, and they had to service all of their debt with their cashflow. And so if you raise a few billion dollars for a buyout, you have to pay interest and sometimes principal on [00:11:00] that debt. And so what you don't want to do is take a business that's throwing off, let's say it has 6 billion revenue and it's throwing off 600 million of cash. You don't want to lower pricing across the board of that retailer and take your 600 million cash down to 300 million or 200 million because you need that cash to service your debt.

Michael Kravshik: Yeah.

Larry Cheng: And so that's the kind of the sticky wicket that you get into.

Michael Kravshik: Okay, got it. You know, we're at, I think by the end of 2012, Chewy's at about 25 million in revenue. Were they still losing money at this point on a per unit basis?

Larry Cheng: No, they were not. Their gross margins and contribution margins were low, it was probably like 12% gross margins, probably like 6 or 7% contribution margins. The difference is, you know, obviously cost of product is before the gross margin and then cost of shipping and fulfillment is what's taken out before contribution margin, and that's kind of where they had gotten to.

Michael Kravshik: I see. And so was the company overall still losing money then at that point?

Larry Cheng: Yeah. It was still being self funded [00:12:00] by Ryan and Blake, but not, it was losing money very modestly. Okay, but again, that's something that those competitors just wouldn't have even entertained because they want that margin to service the debt or to drive dividends or whatever it might be.

Michael Kravshik: That's right. Okay, so now we're getting to the point where you actually do decide to invest. So what changed your perspective of the company and what drove you to eventually you invested 15 million in a series A in 2013.

Larry Cheng: Yeah. So probably the change agent in my life was, I was about to get a dog. And so as a, my dog's name is Coco and in the process of getting a dog, which was the summer of 2013, I started to understand and feel this change that pet owners wanted to give their pets the very best food. I wanted to do the same thing, I started to see that back in the early, you know, 20 years ago, it was Purina at the grocery store.

Michael Kravshik: Yeah.

Larry Cheng: That was the cheap stuff. And now it's organic, it's human grade, it's like wild cod, it's grass fed, it's everything is like the [00:13:00] high end stuff. So yeah, that's when I started to appreciate this sea change, I started to appreciate the change in pricing. And I knew that my mind at Chewy's business model was working, so it's, and everyone who did not dive into it presumed it didn't work. But what had changed is, as I mentioned in the pets.com day, the average order value might've been $25, a Chewy's average order value is $75. You can make that math work, and Chewy was all because of this change. And so I went back to meet with them in August of 2013 and ultimately we got into a diligence cycle and we closed our series A investment in the company in October of 2013 for $15 million. And we actually established the board with that investment, it was me, Ryan and Blake.

Michael Kravshik: I guess that's what kind of helped you overcome the pets.com stigma, let's call it. Is that you felt that the market itself had actually changed meaningfully?

Larry Cheng: Yeah. There were also another change, not just the [00:14:00] purchase dynamics of consumers around pet food, but there's just a lot more ecommerce shoppers today. You may recall back in 2000 when pets.com launched, I remember the idea that you would buy shoes online when you can't try them in a store was ridiculous. The idea that you would buy a sofa online made no sense and, but now you buy everything online and so.

Michael Kravshik: Yeah, I mean, those 15 years, the world totally changed when it comes to ecommerce.

Larry Cheng: Yeah. So the economics change, the market size change, the human consumer behavior change. So it's this thing where investors, they when a business model fails historically, it's like, it's ruined forever. And that's just not the case because, Hey, you know what, technology changes things.

Michael Kravshik: No kidding. Yeah, I mean, it's a pretty, it's actually a really great example of finding an opportunity that so many people were turning down because of that. I don't know if you want to call it like the emotional or the psychological ramifications of past events that obviously you and your partner saw [00:15:00] through, so that's really interesting. How did you structure this round given, I mean, the company's losing money, it's not really like you guys aren't a VC fund in the traditional sense. So how did you think through that? And what was your investment thesis in terms of payback and all of those things, because you need that scale that you're talking about to make sense in the long run.

Larry Cheng: Yeah. I mean, I think the biggest thing in diligence that we learned and I'll get to sort of how we thought about scaling the business was that the company acquired customers and didn't lose them. They just kept coming back and buying over and over again, we call this cohort retention. And we saw customers come in as a group and stay as a group for years, and that means you can take capital like ours, scale all the service and the customer acquisition and know that you have, you're doing that for a customer that has a long lifetime value and will be with you for a long time. And we can talk about why they were there for a long time, they did a lot of things right, but we wanted to use this capital to scale acquisition and to build the [00:16:00] infrastructure of the company. And I would say, it was structured like a pretty traditional growth equity investment.

Michael Kravshik: I guess a couple of things out of that, I mean, we'll certainly get back to why the company was retaining customers that has a lot to do. I mean, spoiler alert, a lot of it has to do with this kind of customer centric focus that you mentioned Ryan had right off the top and we're going to get into some of the decisions that you made around that. Can you share with us any of the specifics of that round? I don't want to, you know, pry into an area that we can't cover, but just anything there that you think is worthy of note or mentioned.

Larry Cheng: Yeah. I'd probably need to keep the specifics quiet, but it was $15 million. It was all growth capital, it was preferred stock, it was sort of done an evaluation that gave us minority ownership. And so typically our investments, we take minority ownership. Typically we have some governors, which we did have here just to protect our capital from being spent overnight on a Super Bowl ad or paying us, paying the CEO $10 million a year, and those types of things. And but other than [00:17:00] that, it was pretty plain vanilla, it's sort of interesting. Ryan negotiated a tough deal, and there was a point when we thought if the valuation changes at all, like if he comes back and he says, I want 3 million more free money, we were like, we're going to walk. And far after the investment was done, he said, you know, when we were negotiating that deal like I thought we were a hose because we were running out of cash, and I thought you were totally overpaying on evaluation, I could not understand why you would pay that valuation. And so, but he said, I felt like I had to negotiate hard, so you felt like you were getting a good deal. So you're like, I thought, all right, well, you put out a good poker face because we had just reached the point where we're like, we're ready to walk from this. Well, he's desperate for our capital, but we didn't know it. That's amazing, and of course, now in retrospect, when you think, oh, if it was 3 million more in valuation, I'm sure you still would have made a killing on it either way. If we've had to pay 200% higher price, it would have been a great deal.

Michael Kravshik: So now you're [00:18:00] on the same team and this actually brings us to our first interesting strategic decision that you had to make at the time, which was to actually decide whether to announce the financing or not. And so, you know, I think we're all used to seeing these big flowery, you know, press releases, Oh, X company raised X million dollars. Everybody's so happy, you get that standard quote from the CEO and the standard quote from the investor, how everybody's excited about the future, why wouldn't you do a press release?

Larry Cheng: Yeah. So we opted not to announce this financing and we generally, actually absolutely, adopted a belief not to engage in PR and not to tell the world about how well we're doing. The general thought process around that was a couple, one, we just didn't want to tell the competitors that this is now a fundable space and attract more capital into it. We didn't want to tell Amazon who we always had a healthy fear of that we're doing well, and we also were always negotiating terms with our vendors and we wanted to cry poverty across the board and it's hard to do that when you raise [00:19:00] millions of dollars. And we didn't want to adopt a culture where somehow raising capital is something to be achieved or celebrated like it's some big achievement. And so we opted at that time to say we're going to stay silent on this business until we reach a billion of revenue, which is an ambitious goal because who knows if that's ever going to happen.

Michael Kravshik: Yeah, you're sitting at like 30 or something at the time.

Larry Cheng: At this time, we were sitting about 65, 70.

Michael Kravshik: Oh, 60.

Larry Cheng: Okay. Yeah, I forget how quickly Chewy grow it. And we stayed silent and and we stayed signing for years to come. And it's hard, right? Because announcing can have benefits. You can, it attracts employees, it tells you, you have firm foundation, you have capital, you have balance sheet, all that good stuff. But Ryan to his credit was relentlessly focused, he thought all of that noise would be a distraction.

Michael Kravshik: One of the things that's interesting, you mentioned Amazon, I mean, I have read a little bit about kind of the Zappos story, which they were, you know, they were an ecommerce shoe company. And I mean, Amazon, [00:20:00] because they were attracted to it because Zappos was doing so well, Amazon pulled some, I guess, what are pretty standard Jeff Bezos moves. And it was definitely a negative impact on their outcome, because Amazon thought that they could make money there. So, I mean, this makes a ton of sense in retrospect and again, I guess you're battling those margins this entire time. So that negotiating position with your vendors becomes incredibly important. So now we're in 2013, and by the end of the year, as I understand it, 75 million in revenue. So let's just trace that back 2 million, 25 million, 75 million, I mean, the growth rate isn't quite as fast this year, but oh my god, it's outrageously good. It's hard to hit that, like whatever 10,000% growth when you actually are starting at a meaningful number, is Chewy profitable at this point in time? No still no, okay. [00:21:00] And I think one of the big changes at that point is you decide to build out a more, let's call it formalized board. So, talk to us about the thought process of around board selection. Who did you want? Who did the founders want? Why like, what's the benefit at this point to the company other than the additional governance, but how does that help the company grow?

Larry Cheng: Well, I think there is a benefit to governance. I think that's a healthy set of guardrails for the company, but then hopefully you build out the board with individuals that can bring complimentary but impactful strengths to the company. And so as I mentioned, it was Ryan, Blake, the two Co-Founders, myself, but there was room for another board member or two. So I asked Ryan, if you could anyone on the planet to be on your board, who would you want it to be? And he gave me two names. One was the founder of Costco, and the other was, his name is Mark Vadon, who was the founder of Blue Nile and Zulily. And Mark's claim to fame is at that point in time, Blue Nile and Zulily were $2 billion unicorn ecommerce [00:22:00] companies that had achieved the public market status. And there wasn't anyone else who had built two independent billion dollar e-com companies except him. And so I made it my personal mission to go get them, I flew to Seattle where Mark is based. And ultimately I remember sitting down with him at the four seasons in Seattle for breakfast, and I walked him through some of the Chewy story and by the end of the breakfast, he was interested. And I will tell you, the one slide in the deck that was particularly interesting to him was what we discussed before was the cohort retention. It's the fact that customers would come and they would not leave, and he looked at it and said, this looks like a Amazon prime. And it kind of does at a somewhat different scale, but we were able to get Mark to join the board and that actually precipitated us raising our next round of capital the Series B financing.

Michael Kravshik: Yeah. So I was gonna ask, this is now in 2014, Chewy raises 30 million, what was the purpose for this funding round?

Larry Cheng: Well, so we had to [00:23:00] make a big strategic question, which was, how are we going to expand our fulfillment capacity? And this financing round was to do that. So we're scaling, right? From 2 to 25 to 75, and we're on our way to 100s of millions of revenue. And we were doing it out of a third party logistics provider, a 3PL, which is really a company that specializes in has warehouses that they use to fulfill. So the order that comes into your website goes to there fulfillment center and they ship it to the end customer. And we made a very big strategic decision at this time, which was very nontraditional, which is we decided to actually bring fulfillment in house, we decided to build out our own warehouse, build out a staff with our own people. And this was being done in Pennsylvania, which is kind of an East Coast hub and we decided to build it pretty close to our 3PL warehouse. And that's what the capital was used for, I would say most e commerce companies, [00:24:00] if they were to face this decision, they would stick with a 3PL, because they would say, you know, it's not our core competence. We're not logistics people. We're not fulfillment people. We don't have those people on staff. All of that was true of Chewy. But we were so focused on the customer that we felt like we needed to own customer experience and we believed fulfillment was part of that. So we built our first fulfillment center in Pennsylvania and that was a huge decision that was not without pain, but it became very strategic over time.

Michael Kravshik: I want to unpack this decision from a couple of different angles, and I'll leave those listening with the catchphrase. I remember the way that you described it to me at first was disaster. So this is what we're working from here. So the thinking here is that your own fulfillment center will do what, you know, decrease delivery time. Is that the primary consideration here? Are there other pieces to this?

Larry Cheng: There's other pieces. Like, so we could staff at 24/7/365, which we did. It means that we could take [00:25:00] orders in at 5 PM and inject them into the FedEx system at 6 into 6:30 PM. So you could literally get it the next day. It meant that we could optimize it for our type of heavy, large format, pet food bags, which is not what any 3PL is organized for. So it's more efficient. So we can lower cost of fulfillment over time and provide better service and not be dependent on a 3PL that can't grow with us. And so I think it's a combination of service and economics that we decided to do that.

Michael Kravshik: Can you, for a moment, steel man the opposite argument? Like, what was the argument for remaining with a third party logistics company? And, you know, I imagine some of these things you could probably, especially as you scale, you could solve through a partnership with a great 3PL. But, so tell us, what was the argument the other way around?

Larry Cheng: The argument the other way around is there's no one in your company that knows how to do this. There's no logistics or fulfillment experience. It, it costs a ton of CapEx to do it yourself and it might not [00:26:00] work. You don't have scale, so everything's going to be inefficient. And these are the experts. And by the way they have other fulfillment centers around the country so that you can scale with them. And just essentially you're taking away your CapEx costs and putting into a variable cost to an expert provider who's potentially better at it than you would be. And that's the argument that most people make. And you can stay focused and use your capital on things that are more strategic to the business.

Michael Kravshik: And this was, I mean, you'd mentioned you the company raised 30 million in this round and this was majority for that. Like, I mean, I imagine the CapEx here was, you know, tens of millions. Is that what we're talking about here?

Larry Cheng: When it was proposed at the board level, we thought it was going to cost about $5 million, but it ended up being more like 10+. But it was interesting. Things went haywire. So as I meant, as you mentioned, it was a disaster when we launched. So what happens is you start to build out your warehouse and your 3PL gets wind of it. So your 3PL knows that you're looking to transition. So they start to play games, they start to screw you, they [00:27:00] start to nudge the product. They upcharge you. Our software didn't work. And so we just, we were building our own warehouse management software that didn't work for a while. By the time it worked, we wanted to get product. Our 3PL wouldn't send us their product, so we had to go buy it. Back and very inefficient means through distributors at higher prices. In the meantime, we are, we couldn't fulfill our orders because we didn't really have a functioning fulfillment capacity. So orders were backing up, which has never happened in Chewy's history. We went back to having negative gross margins on some or many orders because we were buying so inefficiently and it almost killed the company, to be honest. We were hiring people from Amazon fulfillment centers and sending them right to our Pennsylvania facility and just having them live there until it worked, but it took probably four or five months and we got it all squared away. We got it, we got the fulfillment center operational and working and with inventory. And then, you know, since that point in time, we ended up building several more across the country. But but it was almost a company killing event. [00:28:00]

Michael Kravshik: One of the things that I'm curious about is you made this decision and in large part, as you said, there's an economic component, but there's also a customer satisfaction component there. And then for that first four or five months when you're dealing with this kind of chaos of the transition assumedly, your customers are having a pretty bad experience. Did Chewy experience some additional churn that they were used to because of what was happening then?

Larry Cheng: We must have I'm sure we lost a lot more customers during that time than we would normally, you know, there weren't many other e-commerce options at the time, and so maybe we were a little bit fortunate because we were kind of an early mover but it was a hot mess and it's certainly for a company that strives for just absolutely best in class service. We weren't doing it for a period of time. So that's, that was painful.

Michael Kravshik: As you look back on it now, painful, but the right call?

Larry Cheng: 100% the right call. It ultimately became very strategic because we got better at shipping pet food in this country, we got better than Amazon at it. And [00:29:00] so we could actually get to some places faster than Amazon and enabled us to give consistent experience every year our cost to fulfill got lower. And so we negotiated better rates with the carriers than we would have gotten at a 3PL. And so it became a core, almost barrier to injury against other competitors in the space.

Michael Kravshik: Yeah. Well, and over the next couple of years, you, as you mentioned, you did a huge operational expansion. You developed more of these fulfillment centers. What did you learn from that first one that was a little bit of a disaster that allowed you to apply those lessons to these others and become, I mean, better than Amazon. That's a really strong award to have there.

Larry Cheng: We needed, ironically, we needed to hire a lot of Amazon fulfillment center people to get it right. And so, so we were literally, daily, like, we were reaching out to people via LinkedIn that worked at Amazon, and we were poaching hundreds of Amazon fulfillment people every quarter, and [00:30:00] obviously it helps that you got your software working, you got your, the mechanics of your physical infrastructure working and it's easier to replicate, but but the people, you need talent and and we pulled that from Amazon.

Michael Kravshik: I would find it very difficult to make that decision at that moment in time. And as you look back on it now, it was such a good one. What is there to kind of generalize from that decision and you know, how do you apply that same approach or learning or whatever it might be to some of the other companies that you work with.

Larry Cheng: I think we arrived at the decision because we were starting with the solution first which is really the mission, which is we wanted to be the best experience for customers in the pet food space period. We thought that Amazon was good at transactional ecom, but not good at service. And so if you say we have to win on service, otherwise we could always get killed by anybody. Well, what are the components of that and you work backwards. And one of them is we had to be as [00:31:00] good or better than Amazon on fulfillment. So you, the customer didn't feel like they were taking a step back from a shipping experience. And so it became very strategic. Like there's no way you can give a customer a great experience in this day of e-commerce without shipping as fast as Amazon. There's no way. So we were just, we had a true north, which is great customer experience. And we worked backwards to make sure that everything plugged into that.

Michael Kravshik: Yeah. I mean, it seems, you know, companies will have these true north that they set whatever it is. Whether it is customer experience or growth, but this is one of those moments where it's easy to stray from that because the decision is so hard. Was the founding team going back and forth a lot on it? Where did you stand? Were you supportive of their decision? Were you skeptical? I imagine at least somebody must have been sitting there being like, you guys are nuts. So just, I guess, help us understand the feeling in the boardroom [00:32:00] or whatever the appropriate room would be at that point in time.

Larry Cheng: I think there was a healthy amount of skepticism and concern. It was $5 million. We had raised something like 30. We understood the logic of it, and we supported it. It became a lot. If you said, it's going to be 15 million out of 30, we might not have been so amenable, but, but we didn't know that at the time, so maybe ignorance is bliss on this one.

Michael Kravshik: Yeah, the ignorant optimism helped you out.

Larry Cheng: Yeah, that's right. That helped out. And I don't think anyone appreciated how hard it was going to be. I don't think anyone appreciated how important it was going to be. And no one appreciated how expensive it was going to be. So it all worked out.

Michael Kravshik: Well, that, I mean, I think that's like a cliche about entrepreneurship and in general is that if you actually appreciate how hard it's going to be, then nobody would be, you know, silly enough to actually do it. So you need some of that naivety to to jump right in. And I think that this conversation is really interesting because it drives right to the next big decision [00:33:00] that Chewy had to make, and that was whether to market the product nationally or regionally. So what were your competitors doing at that point in time?

Larry Cheng: Not just our competitors, but every e-commerce company I've ever met, if you can ship to the entire country from a fulfillment center, you do and you market across the country nationally. And that's how you drive revenue and growth and increase your valuation and so forth. We did not decide to do that. We actually we decided to only market to within a two day shipping radius of our Pennsylvania facility, because that's the only facility we had.

Michael Kravshik: Wait, so how, how far is the two day shipping radius? If we're talking about Pennsylvania here, like, are you getting to the Northeast or like?

Larry Cheng: Yeah, you're getting to the Northeast and you're getting to into Florida. And so you're kind of covering good chunks of the Eastern seaboard, I would say. So maybe call it one third of the population, maybe a little bit less. And so we decided to only market to them precisely for the reason that we wanted them to have a good customer experience. That was the [00:34:00] true north, right? And so, so if you market to California and you get a customer and you ship it from Pennsylvania, Unless you're shipping overnight, which doesn't work ground is going to take four or five days, maybe longer. And and we thought that's a bad experience. So we'd rather not acquire the customer then and give them a bad experience then. So then we wanted to acquire them and give them a good experience. And so that we actually constrained our market. So we ended up doing about a couple hundred million of revenue that year, 200 million on like a third of the country. And so we did still get orders from California because obviously we didn't restrict orders, but we didn't go seek them. But if you look at a heat map of where orders are coming from, it was all from the Eastern seaboard. And that's because we artificially constrained our market in the name of customer experience.

Michael Kravshik: Again, I imagine there must've been some skeptical people involved here. Like, who was pushing back on this decision? Because, you know, it's easy to see that you might've been kind of losing out on that two thirds of the country that you weren't supporting. And[00:35:00] what kept your conviction or the founder's conviction that this, again, I mean, this kind of prioritizing the customer service over literally everything else was the right move.

Larry Cheng: Maybe this healthy fear that, If we didn't, we would lose. And we would lose to Amazon. And so we knew at any point in time Amazon could fundamentally cut pricing in the market and be uneconomic and irrational for as long as they wanted because they have bigger balance sheet than we did. So we felt like it was a non negotiable essential. It actually wasn't that hard of a decision. Now, to be fair, we're growing from 75 million to 200 million, which is great growth. It's still 3x-ing. It's not like we're saying like, Oh no, 200 million is not good. We should be 400 million. And, but so, you know, maybe it'd been a tougher decision if our growth had moderated and, but it wasn't. And that sort of lends credence to some of the decisions we were making.

Michael Kravshik: Just on that, I mean, what did you view at the time as the TAM or the Total Available Market, if we're talking about just a third of the country, I mean, how big [00:36:00] is the pet food market that you're servicing here?

Larry Cheng: It's funny you ask. I mean, the pet food market is big but the part that was relevant was the online pet food market And it's kind of funny if you looked at all of the market forecasts at the time for the e-commerce penetration of pet food, you just did the math. A lot of the market research studies were showing the size of the market being lower, smaller than the revenues of Chewy. And so, because again, we were under the radar. No one knew how well we were doing. And so I don't trust the market research data anymore because it's all off. And so consistently Chewy.

Michael Kravshik: It's like assumptions layered on assumptions, right? You get to, who knows?

Larry Cheng: Yeah we're, we knew our business was bigger than the entire market. So, so there was plenty of spend. I mean, the pet food markets worth of 50 billion in revenue every year. So it's a big, it's a big market.

Michael Kravshik: There's a third decision that was wrapped into the same, let's call it like topic area. And that was kind of how you [00:37:00] wanted your customer service to operate. You had the choice between, you know, automating more things, making it low touch, making it focused on efficiency versus high touch that was more expensive and assumedly providing a better service. So I think we can all probably guess what you chose at this point in time, but walk us through the decision making what really were the different options that you were considering and what was the cost differential or the margin differential or whatever numbers that you can share around that decision?

Larry Cheng: Yeah. So, I mean, in this era, everyone's focused on low touch using technology, don't have people talk to a human being. Provide any information you can through technological means. And that's, we decided the exact opposite. We went high touch. We wanted people to call in. We wanted, we staffed our customer service 24/7/365 with pet lovers, pet food experts. You would get a human being in one ring. We did a very interesting thing where we encourage people to stay on long, stay on the call as long as [00:38:00] possible. And so on a typical day, the longest talk time between a customer service rep and a single customer would usually be over two hours. Probably talking about their dozens of cats. I don't know. But that was, celebrated. It was encouraging.

Our thought process is if we can wow the customer, we'd have them for life. And interestingly, I tried to do the same thing at Amazon. I tried to talk to a customer service rep on Amazon about what pet food to buy. And you will navigate through many prompts and many screens and maybe over 15 minutes, you'll find that you'll talk to someone who is in another country who knows nothing about pet food and the most they can do is search on Amazon and read the product page. Like that's what you can already do for yourself. That's all they could do. And so Chewy customer service reps were are experts and passionate about pets and they were empowered to do some crazy things, which we can talk about. But anything to wow the customer and we will look to scale that. So that was a key decision. It wasn't measured in economic value. It was measured in [00:39:00] sort of the lifetime retention of the customer and that was what made it worthwhile. And we hadn't countless examples where people would talk about our service to others and it actually became a means of customer acquisition. But it was really meant to means as creating the value and the distinction of the company, which is what it did.

Michael Kravshik: Okay. Well, I have to ask about the crazy things. Give us a couple of examples here.

Larry Cheng: Yeah. So, I mean, in the early days and well beyond, we, one rep started to write handwritten notes to certain customers. And so we scaled that and Ryan and Blake would write, sign handwritten notes holiday cards to all of our customers. So millions of them, a customer sent in a picture of their pet to a, one of the reps. And so we, they had a painter paint the portrait of the pet. And we started to scale that. So we sent, we worked with local Miami artists and we had, we ended up sending out hundreds of thousands, if not millions of pet portraits. We had examples where we would learn that a pet had passed away sadly, and someone wanted to return their [00:40:00] pet food. And we would always say, don't return the pet food, like give it to the shelter. Like that's fine. And we'll give you a credit and refund. But then we would send them flowers when their pet had passed away, expressing our condolences. And, you know, we were doing that genuinely, but it's not many companies that when you stop being a customer, that we give you something. And Now obviously you might become a customer again, but we sent out many bouquets, but I do remember one time someone received a bouquet from us and they posted on Facebook and it was, it just kind of went viral on Facebook and we think we acquired like 5,000 new customers from that post. And like, but anyways, there's, we've looked for sort of magical things that customer service reps were doing. We empower them to do it and then we scaled it.

Michael Kravshik: Yeah, I mean, I don't know a heck of a lot about how most call centers work, but I do know that the primary kind of metric of efficiency is how fast you can kind of complete or satisfy a customer like get on the phone, [00:41:00] you know, solve their problem and get off the phone as quickly as possible. So you can take the next call.

Larry Cheng: Exactly.

Michael Kravshik: And so just by, you know, bucking that trend entirely, I mean, that, that is flying in the face of everything. Again, I've got to imagine there was pushback here. So who or at this point is are like the people involved in the company is just such a believer in the North Star that you're actually not getting that pushback anymore.

Larry Cheng: No, we believe in the North Star and the financial performance was amazing. So we went from a couple hundred million to 425 if I recall. So this is a special company and we were completely on board. I should know and I forgot to mention our customer service reps. We're located on the same floor of the same building as the CEO. And so, you know, it's not like they were in some low cost territory. They were right outside the office of the CEO. And so that's another dynamic where that shows how much we cared. And that's how we scaled our customer service rep. So, no, everyone was on board. We, again, viewed that as our [00:42:00] core differentiation.

Michael Kravshik: Yeah, well, and I just want to remind people, I mean, these are B2C customers, these are individuals, you're not, you know, it's not like you have a handful of very important, high valued B2B customers here, these are just the idea that, you know, the CEO was hand signing all of these letters to people is just outrageous, but it really emphasizes the kind of focus that I assume Ryan had around it.

Larry Cheng: Absolutely. And everyone says they're customer centric, but that's really, I found that actually not to be true at all. I think most people are not as customer centric as they think, because you almost have to be a little bit economically irrational and a little bit crazy to be totally customer centric because not everything that's right for the customer makes sense. And so the question is, how far are you going to push that now? Now that I'm advocating for doing everything at all costs, we could do it because we knew we had the customers for life. And that, that opens up room.

Michael Kravshik: Well, and what's interesting is, [00:43:00] you know, we've talked about Amazon being kind of the big scary monster for Chewy and Jeff

Bezos is known for, you know, Oh, we're customer centric. I mean, I've, you know, you hear these stories of him calling customer service and if he doesn't get an answer in like less than two minutes or whatever, he fires a couple of people. So, so this is something that, you know, at least in how they talk about it, they describe themselves as very customer centric. And to be fair, Amazon is a lot better than a lot of companies I know on that front.

Larry Cheng: 100%.

Michael Kravshik: So it's interesting to kind of take that extreme that Amazon already is and kind of say, you know, we're going to, we're going to raise you on that one.

Larry Cheng: 100% yes.

Michael Kravshik: I don't know if you remember any of the specific numbers, but I am kind of curious, like, what was the margin impact of this decision to be more high touch?

Larry Cheng: It was negligible. We had a, I don't have the number off the top of my head, but we did have a, sort of a variable customer service cost per order. And it was kind of in the [00:44:00] cents, like, range. And because we could amortize that across the entire customer base, because not everyone calls customer service. But your company's brand is built on the narrow set of customers that engage with you, who you treat really well. And so, so it was not actually that expensive. It was just very non traditional.

Michael Kravshik: Okay, so now at this point we're kind of in 2015 in the story you mentioned, we're at like over 400 million in revenues and you had a pretty interesting decision to make at this point because you're one of your really big competitors, Petco wanted to acquire Chewy for over 400 million.

Larry Cheng: Yeah. Yeah. So Petco came knocking and it was our first sort of interest, and they knew how well we were doing. And what happened is for both Petco and PetSmart is they started to realize that they were starting to comp their same [00:45:00] store sales down, like we were taking share across all of their stores very slowly. And then ultimately, they started comping down. So Petco reached out to us and wanted to acquire us. And as a board, we had a decision to make. And to be honest, we were very favorably inclined to take it because it Ryan's a paranoid guy and you never know what Amazon's going to do, but ultimately Petco pulled out because they couldn't imagine handing over hundreds of millions of dollars to the management team, the founding team and

and expecting them to work. And so they just couldn't conceive of that. You're a larger company buying a younger company. You need that company to be run well by the people who are running it. And I get it. Like if someone's making a significant amounts of money then how can you believe that they are going to continue working? And that's what Petco couldn't get their head around.

Michael Kravshik: Was this a good valuation considering the amount of revenues, the amount of growth, the I don't know if you were now profitable at this point in time, but tell us what was the company like? And, [00:46:00] you know, you're an investor. Does this seem in retrospect, like it was a fair valuation or was it low?

Larry Cheng: At the time, it definitely seemed fair. I mean, it may not seem fair now because back at that time, there was still nothing in the e-commerce world going public. Wayfair was kind of the public company and it was just treading water. Like no one believed e-commerce companies could make money. But at that time, people did care about companies making money. So, so it's just there was not a lot of value to be had. So it was a very reasonable and fair offer that ultimately didn't work out. But, you know, we'll talk about this, I'm sure in a bit, but the markets changed and got much more bullish on e-commerce over time. But at that time it was it was more than fair.

Michael Kravshik: Interesting. Okay. And just kind of give us the sense of the company at this point, were you on the West coast by now? Were you profitable?

Larry Cheng: We were, depends how you define profit. And so we were not EBITDA profitable, but we were getting very close to to being cashflow positive. And [00:47:00] we can talk about that, but we were nationwide and we were scaling fast. We, we had finished a 400 million a year and we're about to do 900 million in 2016. So, we're scaling pretty fast.

Michael Kravshik: Okay. So what was the difference between kind of your EBITDA or let's say the material things that were different between your EBITDA and your cash profitability, what were the areas that actually caused that great of a difference that you went from kind of almost breakeven to negative?

Larry Cheng: We viewed early on working capital management as key a strategic and so we as we scaled what a lot of companies would have done was is go back to your suppliers and negotiate better prices. What we did was we went back to our suppliers and negotiated better, better payment terms and what happens is we were getting inventory in. We were selling them in like that inventory within a month. So our inventory turns were 11. And then we were paying for that inventory sort of 30 days after we sold it. So 60 days after we bought it. And so [00:48:00] we were getting paid before we had to pay. And that is essentially a financing event that our manufacturers were funding. As you scale and you get 900 million, a billion of revenue every month, every 30 days, that's like an 80, 90 million dollar financing event. And so, so our, we were cashflow neutral later this year, but we were pretty significantly EBITDA negative. But we cared more about cash because that's the Amazon that's the Amazon way. It's Jeff Bezos actually thinks EBITDA is a very bad profitability metrics and he cared about ultimately free cash flow and operating cash flow.

Michael Kravshik: Yeah.

Larry Cheng: And that's what we cared about.

Michael Kravshik: That's really interesting. And I imagine all of that additional cash flow, you're then reinvesting into growth at that point in time. And so that's,

Larry Cheng: Well, we poured that into customer acquisition. And so again, so it's a beautiful model, right? Our manufacturers are giving us capital and we use that to acquire customers, [00:49:00] who then stay with us forever.

Michael Kravshik: Yeah, and then I mean, I've got to imagine some of the thinking as well in a couple of years when we're that much bigger, we'll be able to renegotiate prices even more deeply once that becomes a priority rather than driving that cash for growth.

Larry Cheng: Yeah. We ultimately moved our gross margins up into the twenties. We may recall the early days they were in the, like, closer to 10. And I will know, which is interesting. Like we interviewed people from the procurement divisions of Petco and PetSmart. These are like much larger companies. These are 5, 6 billion revenue businesses. And we were getting better payment terms from our vendors and suppliers than they were. Now, how is it possible that a smaller company is getting better payment terms than a larger company? Well, it's because we cared about it. No one in Petco, PetSmart, procurement care, cares about payment terms because they don't own the balance sheet. But we do. We did. And Ryan would even get on and negotiate some of these terms. And so it was, working capital was viewed as [00:50:00] totally strategic for us.

Michael Kravshik: That's interesting. Yeah. And I would guess given what you've just described that these competitors were probably getting better prices than you, but you were taking advantage of that float, let's call it the working capital float and driving that right into growth that was ultimately getting you the scale that will feed, you know, those discounts later on. So it's a great strategy. Absolutely.

Larry Cheng: And we were keeping our pricing low. So, so we took margin out of this market. I t was call it a $50 billion market with with X gross margins. And we just collapsed that and that hurt and has hurt the retailers. And so, you know, that was another decision we made. We have these recurring customers, right? You could, what we could do is raise prices on that, but we never did that. We kept them, we matched, we want to make sure we're the lowest online. And we just thought of a long run. If you know that you go to Chewy and it's the lowest price, then you'll be in good shape.

Michael Kravshik: Let me ask you, had Chewy expanded outside of pet food? Were you [00:51:00] ultimately offering other pet products that was impacting these competitors? Because you said that's one of the real reasons that that your competitors started knocking on the door and sniffing around.

Larry Cheng: Yeah, we offered treats, we offered hard goods, crates, toys, costumes, whatever it may be. We did find, and interestingly that when we acquired, spent money to acquire customers into hard goods that are non recurring, the lifetime value of that customer is a lot worse than if we spent to acquire for a recurring customer, and so it's not like those cross pollinated. Well, I mean, if you bought food, you might buy hard goods, but the hard goods customers didn't always go and become by our food. And so, so we focused our acquisition more on the recurring customer than the non recurring one. And that that made more sense economically.

Michael Kravshik: Yeah. And I guess those additional products just ended up helping you increase your basket size on those on those customers that were there from a recurring basis. So now it's 2016 and you get your second acquisition offer and this [00:52:00] time from a company hailing from from my home and in the North, it's a company called Canadian Tire. And that was a $1.2 billion offer. Did you take it?

Larry Cheng: We wanted to, and again, this was a deal that ultimately was taken to the board of Canadian Tire and I think in a very rare moment, the board did not support the recommendation of the team or CEO, and so. The deal fell apart. I think we were very pragmatic. Like, Hey, a billion dollars is a lot of money. It's a big win. Everyone's a huge winner here. And it was, to be fair, it's a gutsy, gutsy call by the Canadian Tire CEO, Michael Medline at the time to buy a pet food. Like the Canadian Tire is not even a pet, pure pet player and in the US and had they actually followed through on it, it would have been an amazing decision for [00:53:00] them, but in a terrible decision for us but thankfully their board stepped in the way of it.

Michael Kravshik: Okay. Well now you're two acquisition offers that seemed great at the time and then terrible in retrospect that you that you lucked out in not completing. And it's actually just as a quick side note it's interesting when I talk to a lot of people and this seems to happen all the time where people see a good offer and it's like, well, you know, it'd be silly not to take a billion dollars in this case. And then afterwards they go off and God, we didn't take that billion dollars. So this isn't as rare an occurrence as as it might seem.

Larry Cheng: Well, it's now you see the entire inverse has happened in this economic climate. I think everyone would have taken whatever offer they could have gotten in 2021. And like the entire tech world, probably like 98% would have been better off taking whatever they could get in 2021 than where they are today.

Michael Kravshik: Fair. So much of it has to do with the market cycles. Now you have a different decision, not acquisition related. We're going back to the business now.[00:54:00] And you were deciding, well, how are you going to continue to drive growth? Because I mean, yeah, again, we're like, this is 5 years into the business. The growth is absolutely insane. And you have this choice of, do you focus on tried and tested channels? These are like kind of growth channels or selling channels that are economic, that, you know, they work, etc etc, versus you know, innovating a little bit, taking some risk with some new ones. What was the catalyst for considering these non tried and tested channels? Were you, were your current channels running out of steam or were you just thinking that was going to happen in a couple of years time?

Larry Cheng: We were sort of planning for the future. It wasn't that the existing channels like Google AdWords and so forth are running out of steam, but we felt like if we were going to capture the whole market, it wasn't going to be through Google. And it's not as though our our merchandising strategy allowed us to continue to expand more SKUs and having more words to go market around. [00:55:00] So, so it's a big lesson actually, when we launched television advertising and quite aggressively and to try and learn. And get better at it. And it was very uneconomic at the beginning. It was sort of 3x the CAC of our normal channels. And almost every company, and it might be the right decision, says, Oh, well, one channel is the CAC is X and the other channel, the CAC is 3x. Well, why don't we just spend on a channel with that? That's X. But what happens is you become very channel concentrated and the economics of that channel can change. And so there is value to diversifying to "uneconomic channels" and hopefully trying to make them economic, which is what we did in TV. We, we lowered the acquisition costs down into the zone of our paid performance advertising. And we also launched direct mail, which became started uneconomic and became economic. And that enables us to really go after market which we couldn't have done purely on paid performance advertising. And so it is a lesson learned, like there is merit to diversifying channels. Even if it's a little bit more [00:56:00] expensive, because there's value in diversification and the cost can change over time in both directions.

Michael Kravshik: Yeah, and just for anybody listening that isn't familiar, CAC, what Larry is referring to is Customer Acquisition Cost. There, and so essentially what you're saying, if I could paraphrase Larry, is okay, obviously you generally want to go with the cheapest channels, but at the same time there's at least two different variables that aren't captured by that. One is just the value of diversification. And that if a particular channel you know, isn't as effective as it used to be, then you're kind of screwed if you're relying entirely on that channel. So there's just kind of one, let's call it like, hedging to a certain extent, hedging your ability to continue to grow, but to that, you know, you spent a lot of time and energy actively trying to bring that CAC down for those uneconomical channels and what was like, what drove your ability to do that? You mentioned TV and direct mail. How did you manage to decrease the acquisition cost through those channels.

Larry Cheng: So [00:57:00] like in television, we learn how to buy by capacity and inventory more economically over time. We, it's usually the way when you start out with your test, there's no way that's the most efficient way to acquire.

Michael Kravshik: Yeah, of course.

Larry Cheng: We learned about content and how, what content works and doesn't, and you got better at that. And and so, and then you actually, in some cases, if you're more consistent with the channel, it becomes more economic because there's the repetitive dynamic of it. And so there are a number of things, but like we, we cut our initial customer acquisition cost CAC probably by a third when, after we started. So, there's a lot, there's a lot of low hanging fruit. So I don't think your starting CAC is the same as your ending CAC.

Michael Kravshik: Well, yeah, there's a really good lesson here for any company. If you're exploring ways to grow and you see a channel that just initially looks like it just doesn't make any sense to kind of press pause on that. And before you go and write it off to actually decide whether it's worth exploring, investing a little bit in, seeing if [00:58:00] you can bring that cost down and, you know, also recognizing just how important it is. I one podcast we we did a long time ago with the founder of kind of a financial services company, they're like one of the robo advisor companies, this line always sticks with me. He said, you know, the way that we acquired our first 1,000 customers was different than the way we acquired our next 10,000 customers, which was different than the way that we acquired our next a 100,000. And especially as you grow, some of those things that made sense or were, you know, you were able to do at a small scale, you can't do at a larger scale. And so, I mean, maybe the right way of saying it is to not rest on your laurels and to say, well, you know, Google ads is working for us. So let's just keep pounding at that. Eventually that probably won't hold.

Larry Cheng: A 100%. You don't want to be dependent upon one algorithm chain screwing your entire business.

Michael Kravshik: Yeah. And we've heard of those kinds of situations as well. If anybody's familiar with Deeply, they were the ones that we're doing back like about 10 years ago, the Facebook things where you would click in and like every, it [00:59:00] was like a list. Here's the top 10, whatever. And every in between everyone, you'd see, you'd have to like click through an ad. And they were just growing like wildfire. And then one day Facebook changed the algorithm and they went from, I think it was like they were a year in and they were at like 8 or 10 million in revenue down to zero, like in a day. And so that is scary stuff.

Larry Cheng: Totally.

Michael Kravshik: Okay, so now we are approaching 2017, and PetSmart starts to sniff around. And Ryan had a specific ask here, the CEO, Ryan can you tell us what his ask to PetSmart was?

Larry Cheng: He went directly to the private equity owner of PetSmart, which is BC Partners, and said, if you want this business, do you have to give us $3 billion, all cash, no escrow, close in 30 days or no deal. And just to be clear, like that's saying, say 3 billion first of all, is the biggest number ever for an ecom business. No estro means there's nothing on the hook. Like, there's nothing to keep Ryan or anyone [01:00:00] else.

Michael Kravshik: It's a clean deal. They don't have to stick around.

Larry Cheng: It's totally clean. It's all cash. There's no, none of the funny business. It's real dollars and you have 30 days. And like, I'll be honest. I, when he said that, I told him, okay, so you just killed the deal. Like that doesn't, that's not going to happen. No one does that. There's there's no deals of this size with no escrow. Like that doesn't make any sense. And but 30 days later it happened. And the actual amount was over 3.3 because we had some cash on our balance sheet, but BC Partners did it. It was the largest acquisition e-commerce history. Ryan's a gazillionaire. The funny thing is I used to drive around with my kids and whenever I would see a PetSmart, I would say, Hey, Chewy's going to put PetSmart out of business. I'd say that I was saying that for years. And then, so when I came home that day, having this massive return, I told them PetSmart bought the company. They were so unhappy with me because I had like sold my soul or something. We're supposed to put PetSmart out of business, not give them Chewy. [01:01:00] And so on that day, the only one that is that ones that were unhappy were my children.

Michael Kravshik: Got it. I mean, and it was funny. He said, Oh, and we gave them Chewy. Well, he didn't exactly give it to them.

Larry Cheng: You're right. Fair.

Michael Kravshik: Take us into the room as much as you can, whether that's the room with BC Partners. I mean, maybe let's start there. Like what was their reaction to Ryan putting that demand? Was it, did they have to go in, you know, kind of consider that where they thinking in their heads. Oh, this is great. We're going to do it. It's going to be a steal. I mean, what can you share about that experience of trying to get $3 billion for this business?

Larry Cheng: I don't, I was not in the direct dialogue with BC Partners. That was Ryan going off on his own limb.

Michael Kravshik: Got it.

Larry Cheng: I will say this. I would not have done what BC Partners did. And they did it. It was gutsy. It turned out to be one of the best private equity acquisitions in history, because what happened after BC Partners bought Chewy and put in [01:02:00] with PetSmart, they spun Chewy out as an independent company. And they took a company public into a raging bull market. We thought the market might taper back. It was like on a, it turned out to be like a six year tear and e-commerce was going public and valuations that had been stagnant with very few public comps suddenly exploded with interest rates being at zero. And the market cap for Chewy got as high as over $40 billion. And so at some point in that sequence from 3 billion to 40 billion, I'm sure BC Partners sold some or a lot of their position. It turned out to be a monster win for them. A monster win for a lot of public investors who bought in at a relatively decent value. I think it went public and maybe closer to 10. It was a monster win for us and all the Chewy shareholders and a monster win for Ryan. So, and all the employees. And so it was certainly one of these, every one in one, but was it the right decision to sell [01:03:00] to BC Partners and PetSmart? Absolutely not. It was a rare decision where you, it was a record setting deal that we should have not done, but it's okay. Like, we did amazingly well.

Michael Kravshik: Yeah, this is one of those like world's smallest violin situations.

Larry Cheng: That's right.

Michael Kravshik: But it is interesting that you know, you tried to get acquired that first time. Didn't go through. It would have been a bad decision. Clearly that was at like 400 million. Second time at a billion doesn't go through and I imagine in each of those moments, I'm sure you folks and the founders like we're just in a bad place about it because you thought, Hey, we, you know, we were about to have this big win and then it does happen this third time and everybody's thrilled about it and you still look back and you go, Oh, we got too early.

Larry Cheng: Should have done it. Yep. That's how it goes. That's how it goes in a raging bull market. We are very happy. I mean, we've sold some things recently in the last two years. We're like, oh my gosh, we timed it perfectly. So you win some, you lose some. But if your [01:04:00] losses are monster returns, that's still okay...

Michael Kravshik: Yeah, well, there's so many instances in our discussion here where we've come back to just how important market timing is. You get so caught up into the specifics of your business that you forget so much of it is just kind of the winds that are happening at the time.

Larry Cheng: That's absolutely fair.

Michael Kravshik: Okay. So just to wrap us up, I wanted to ask two questions about your overall lessons from this entire experience, other than the fact that, man, you know how to pick them from an investor's perspective, and then also from an operator's perspective, what do you see as the biggest lesson that you have learned through watching intimately this journey from 0 to 3.3 billion?

Larry Cheng: From an investor perspective I think a great place to play and focus your attention is on markets and or business models that all other investors hate. Like that is a, they're go fishing in [01:05:00] those waters for great businesses and you may find the needle in the haystack. That is a beautiful business. And so I'm always as an investor, almost pre inclined to focus on segments that others don't like. And rather than duking it out in segments that everyone does like. If from an operator perspective Ryan, in a similar way, he totally eschews conventional wisdom. So don't listen to what everyone else tells you to do when everyone tells you to market nationally, don't do that. When everyone tells you not to do your own fulfillment center, don't do that. When everyone tells you to keep customer service automated, don't do that. It's just only, he almost says do whatever the opposite is of conventional wisdom. And so there was a very contrarian posture to how he ran the business. And it was a very contrarian posture that got us into the business in the first place as investors and I think at least in this particular example, that served us well across the board.

Michael Kravshik: Okay, so last question then for [01:06:00] you, because we've talked about some of these decisions that were, you know, as you said, contrarian in a lot of ways. Do you think had any of those decisions gone a different way? Do you think Chewy would not have been a massive success or was this the kind of situation where Chewy was going to be huge one way or another?

Larry Cheng: Oh no there were other companies that were doing pet food e-commerce at the time that Chewy launched. PET360, PetFlow, they all kind of stagnated it. Sub a hundred million of revenue and we blew through a hundred million of revenue and so I think the decisions that we made distinguished ourselves with the customer and that created our success so had we not made some of these decisions we probably would have been PetFlow or PET360 and you don't know those companies today because they're not really anything. And that's what Chewy might have been as well. So I think some of these very non traditional contrarian decisions that were very customer centric ultimately drove the entire value of the company. [01:07:00]

Michael Kravshik: Well, Larry, this has been so much fun and so interesting to learn about Chewy's path and you at Volition, you do actually quite a bit of thought leadership. You, you write, you're on you're on a lot of news segments and stuff like that. If people have enjoyed listening to you and want to hear more more from you, where can they find you? What's the best way to to stay connected?

Larry Cheng: Probably at Twitter, which is my handle is larryvc and at the Volition Capital newsletter, which which we produce some of our content for too. So those are probably the two ways we can find our website, volitioncapital.com.

Michael Kravshik: Awesome. Well, we will leave a link out to Volition's website and yeah, just thank you so much for sharing all this with us.

Larry Cheng: Thanks so much, Michael. This is fun.