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Wayfair, Inc. (W)

Q1 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Wayfair Quarter One 2020 Earnings Release Conference Call. At this time, all participant lines are in listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised today's conference is being recorded. [Operator Instructions]

I would now like to hand the conference over to Jane Gelfand, Head of Investor Relations. Please go ahead.

Jane Gelfand

Head-Investor Relations & Special Projects, Wayfair, Inc.

Good morning and thank you for joining us. Today, we will review our first quarter 2020 results. With me are Niraj Shah, Co-Founder, Chief Executive Officer and Co-Chairman; Steve Conine, Co-Founder and Co-Chairman; Michael Fleisher, Chief Financial Officer; and Thomas Netzer, Chief Operating Officer. We will all be available for Q&A following today's prepared remarks.

I would like to remind you that we will make forward-looking statements during this call regarding future events and financial performance, including guidance for the second quarter of 2020. We cannot guarantee that any forward-looking statements will be accurate, although we believe that we have been reasonable in our expectations and assumptions. Our 10-K for 2019, our 10-Q for this quarter and our subsequent SEC filings identify certain factors that could cause the company's actual results to differ materially from those projected in any forward-looking statements made today. Except as required by law, we undertake no obligation to publicly update or revise these statements whether as a result of any new information, future events or otherwise.

Also, please note that during this call, we will discuss certain non-GAAP financial measures as we review the company's performance. These non-GAAP financial measures should not be considered replacements for and should be read together with GAAP results. Please refer to the Investor Relations section of our website to obtain

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a copy of our earnings release, which contains descriptions of our non-GAAP financial measures and reconciliation of non-GAAP measures to the nearest comparable GAAP measures. This call is being recorded and a webcast will be available for replay on our IR website.

I would now like to turn the call over to Niraj.

Niraj S. Shah

Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

Thanks, Jane, and good morning, everyone. We hope you're all safe and healthy. So much has clearly changed since we spoke with you last. The world's response to the threat of COVID-19 has united us all in our humanity and yet has presented each of us with unique challenges to contend with. I'm particularly proud of how Wayfair and our 16,000 employees have mobilized to keep our customers, our communities and each other as safe as possible.

We are working relentlessly to continue to serve our customers across two continents as they navigate their new realities, while managing a global complex supply chain and doing whatever is in our power to support government and community efforts to fight the virus. Though we are all eager for return to normal, we do believe that this unprecedented situation has highlighted the many differentiated advantages we have built as the e-commerce leader in home over the last two decades.

First, I want to briefly update you on the status of our operations. Thomas Netzer, our Chief Operating Officer, who also joins us on this call today, will discuss the practical steps we have implemented within our logistics operations to keep them safe and efficient. Second, I will share with you what we saw transpire during the first quarter as it relates to revenue and customer behavior. I will also update you on the progress we are making against the plans we put in place late last year and which we spoke to you about last quarter to deliver profitability. And finally, we will discuss our efforts to reinforce our strong liquidity position and talk through some exciting leadership and board developments.

Our corporate offices in Boston, Berlin and London transitioned to a work-from-home model in mid-March, and we continue to operate like this today. As governments align on what a gradual reopening looks like, we are preparing for how we transition back to an interactive and collaborative workspace with enhanced safety and distancing standards. The good news is that most of us moved seamlessly to a remote set-up and our productivity remains strong. With technology at the core of our corporate DNA, our workforce has long embraced many of the virtual tools that became essential when working from home.

In customer service, where we already ran a hybrid model, our physical call centers closed and we transitioned to a 100% work-from-home model. Throughout this time, customer service levels have stayed high. Critically, our fulfillment centers, cross docks and last mile delivery locations remain open and have continued to operate throughout. This is thanks to the tireless work of our front-line employees who have quickly adjusted to a number of new processes and procedures to ensure we continue to serve our customers, while keeping our people healthy.

We have also been leveraging our logistics infrastructure in a couple of key additional ways. Most importantly, we've been able to deliver much needed supplies to field hospitals, quarantine sites and other community locations affected by the virus. And secondly, we're working even more closely with our suppliers to forward position additional inventory at our CastleGate locations, so that it can quickly reach our customers.

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As we all rallied as an organization to adjust and keep internal initiatives on track, the revenue trajectory that Wayfair was on in the first quarter accelerated. From January through mid-March, our gross revenue growth year-over-year was tracking in the high-teens with healthy and consistent trends for traffic and conversion. Both new and repeat customer activity was trending as expected, and as typically the case, repeat order growth was outpacing new order growth.

Starting in mid-March, we saw a pick-up in both traffic and conversion, with increasingly strong repeat behavior coupled with an acceleration in new customer orders. This period coincided with customers beginning to shelter in place at home, which led to new needs for essential products like cookware and kitchen appliances, home office products, and children's furniture and play items, and also brought to light ongoing renovation and decoration projects that customers are now taking on.

The competitive landscape also shifted, as many physical retail stores closed temporarily, leading customers to move increasingly towards shopping online across all categories, including home. This pick-up in demand has continued to gain momentum. And in the US, the roll-out of stimulus monies in mid-April served as an added accelerant of new and repeat customers coming to Wayfair. As a result, we have seen gross sales momentum build across almost all classes of goods, across mobile and desktop platforms and across all regions in the US, Canada, the UK and Germany.

As Michael will detail later in the call, this very strong momentum has continued thus far into Q2. We can all debate how long the current dynamics will persist. To be clear, we are not orienting internally around these revenue run rates, but this does create a unique opportunity to serve our returning and new customers and to accelerate the shift to online in our category. We believe there are clearly definable long-term advantages accruing to Wayfair in this period.

It is likely that e-commerce adoption is going to step change across a wide swath of categories. In our case, millions of new customers shopped at Wayfair over the last several weeks. In the process, they discovered the unparalleled benefits of our years of strategic investments to serve our core customer, elements like our vast product selection; rich merchandising and visualization capabilities; robust customer reviews; reliable, visible and fast delivery afforded by CastleGate and the Wayfair Delivery Network; and of course, our high-quality customer service.

We're seeing proof of these customers' positive experiences in strong NPS scores and repeat purchasing behavior from new customers that is consistent with or better than previous customer cohorts. And we expect further brand benefits as word-of-mouth recommendations drive other friends and family to Wayfair. Time will tell how economic conditions affect future purchasing behavior and the size of the overall home market. But there is little doubt that the quality of experience we can offer to new and returning customers during this challenging time will serve us well in the future.

I will remind you that Wayfair's revenue grew through the financial crisis in 2007, 2008 and 2009 even as the total addressable market declined some 30% and more than 10,000 brick-and-mortar stores went out of business. E-commerce adoption accelerated over this time, as consumers sought the best possible selection and deals, and e-commerce platforms like ours benefited quickly from lower wholesale costs, lower shipping costs and lower advertising costs against a recessionary backdrop.

While our business is a much larger size and scale today, we also have huge advantages that we did not enjoy back then such as a well-recognized household brand, a large loyal customer base, deep and strategic supplier relationships, a broader home offering with sales spread across various categories, a proprietary flexible and

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resilient logistics network, and a world-class technology backbone. Even as the operating environment grows more dynamic around us, our internal focus remains the same.

Back in February, we spoke to you about having now reached a stage where investing against priority long-term initiatives such as Europe, building our logistics operations and building teams to fully penetrate the market would be coupled with adjusted EBITDA profitability and free cash flow positive status. We embarked on this plan starting in late 2019, and we are excited by our quick progress. You will have seen the early benefits of the various underlying work streams begin to benefit the Q1 P&L, and we now expect positive consolidated adjusted EBITDA margin in Q2.

To be clear, this is not driven by the incremental revenue we were seeing, but by the aggressive implementation of the plans we set late last year to deliver profitability at our then current growth rate of about 20%. All incremental revenue will be additive, and we would expect it to create significant additional profitability this quarter. While this is exciting, we are most enthusiastic about our internal plans and the statements we made back in February. We are large enough and strong enough to both be adjusted EBITDA profitable and to invest with a long-term horizon. Our plan focuses on driving gross margin expansion, increasing marketing efficiencies and gaining leverage on operating expenses, while still aggressively investing into the future.

Let me quickly remind you of the primary drivers behind each by walking down the P&L, and in doing so, also provide some incremental color as to the variable or fixed nature of each of these line items. Starting with cost of goods sold, which are largely variable expenses, several key levers here are beginning to add to gross margins. First, we are experiencing improving scale benefits across many of our emerging categories and across geographies. In February, we talked about how the variable contribution margins in vanities had expanded by more than 500 basis points over two years. There are many more such examples, and we are managing each of these to incremental profitability and we are also seeing unit economics improve in the UK and Germany.

Second, greater efficiencies are accruing from our logistics operations as we drive higher throughput, improve delivery speeds and incidence rates, and lower cost in the process. Thomas will detail many of these initiatives later in the call. So, I will not go into more depth now. Third, we have invested heavily in our house brands in a few ways, including red carpet merchandising and a growing base of unique products. Our house brands now represent more than 75% of our sales. These merchandising investments are allowing us to unlock incremental margin opportunity. And finally, our supplier-facing services starting with CastleGate and sponsored product listings are growing.

Now, moving on to marketing, as we mentioned on the Q4 earnings call, we have raised the bar on expected efficiency across all marketing channels. This was enabled by more sophisticated attribution technology which facilitated a set of refined targets, as well as a top-down commitment to drive leverage as appropriate for each geography and brand. Our work to aggressively move towards these tighter efficiency targets drove ad spend leverage year-over-year in Q1, and even at normalized revenue growth rates, should yield additional leverage in Q2.

Simultaneously, we are also seeing lower advertising costs in the market due to COVID. This will allow us to drive more revenue and our refined efficiency targets and may result in even more leverage during this exceptional period. As a reminder, roughly three-quarters of our marketing mix is deployed every day across digital channels, with another 15% dedicated to television and 10% to direct mail. We also benefit from having the ability to reach the majority of our customers through e-mail and app notifications, with repeat customers representing 70% of our orders.

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Finally, on OpEx, you'll recall that compensation represents the majority of these costs. In mid-February, we chose to eliminate approximately 550 roles as we drove out complexity and redundancy from the organization, and we expect total OpEx head count to be flat to down for the year. Importantly, we were able to do this without curtailing our ambitious investments for the future. We still have thousands of people working on initiatives that, due to their early stage nature, show very little gains today compared to their large long-term potential.

We continue to closely assess progress against these key work streams via our semiannual strategic review cycle, and we're also closely managing other components of OpEx such as unutilized rent and Google Cloud costs. Though we were initially prudently conservative in talking to you about our path to profitability, we have been aggressively maneuvering the whole business towards sustainable positive adjusted EBITDA. Importantly, this is not based on today's growth rate, but the plan was and is predicated on top line growth rates in line with the pre-COVID-19 period. Later, Michael will discuss with you what this could look like for Q2.

We hope this color helps you better understand why our recent $535 million capital raise was a welcome event, but not a necessity. The global economy is navigating through largely uncharted territory. In this environment, our leadership team all share the belief that having more cash to bolster our balance sheet should maximize our ability to operate from a position of strength through this period. We're fortunate to have the support of leading growth equity players like Great Hill and Charlesbank in the latest convert and know we will benefit from both of their perspectives at the board level. In fact, Mike Kumin of Great Hill has already been a valuable source of advice and counsel over his almost 10 years on our board.

Another exciting organizational update is that Jim Miller, who had served in the Interim CTO capacity since last summer, has officially joined Wayfair as our permanent Chief Technology Officer. After an extensive global search for a pedigreed technology leader with experience in fast-growing companies operating at tremendous scale, we came back to what we knew all along, best candidate was already in-house. We are very excited to have Jim join us full-time and thank him for his years of service as a board member before this. Steve and I look forward to having Jim join a future earnings call to speak with all of you.

Lastly, I want to highlight that while making sure that our employees are safe and healthy and that our customers are well taken care of, we're also working to support our local communities. They've been hit hard, and we feel fortunate to be in a position to help. Among the long list of things we have done thus far is helping set up field hospitals and emergency housing in locations including Boston, New Orleans and the UK. We donated $250,000 to charities selected by our employees that are helping those impacted by the COVID-19 crisis. And the recent Save Big, Give Back event in late April raised approximately $3 million for the Feeding America COVID-19 Response Fund and the UN's COVID-19 Solidarity Response Fund. We're proud of our team of 16,000 people and everything we've been able to do to help, and we're all hopeful that this global pandemic is resolved and behind us soon.

I will now turn it over to our Chief Operating Officer, Thomas Netzer, who is the first of the leaders we will be inviting to join us on these calls over the coming quarters.

Thomas Netzer

Chief Operating Officer, Wayfair, Inc.

Thanks, Niraj. Today, we will focus on our proprietary operations, including supply chain and customer service. Before we dive in, let me share a bit of personal background. I joined Wayfair two years ago as Chief Operating Officer and Co-Leader of Europe and took over the Global COO role almost a year ago. Prior to joining Wayfair, I spent 22 years at McKinsey, where I built global supply chains, served e-commerce clients across Europe and Asia, and co-led the global logistics leadership team.

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Let me quickly set up our conversation by outlining our operations and how far we have come already, after which I want to share with you the future vision that we are working towards. I will wrap up with a description of our response to COVID-19. Our supply chain combines two distinct elements, the vast product selection available in an inventory-light model that drives both cost and reduced risk benefit to Wayfair, as we don't own the goods until the customer places their order, and the way we manage those goods in a world-class way to maximize supplier and customer satisfaction.

The combination of the two is what makes our supply chain management both particularly challenging and an opportunity for differentiation. Our network has evolved over the past decade from a pure drop-ship model to one that allows us significantly deeper and earlier control of the physical and information flow of the goods we sell. Let us walk through a quick example to describe the advantages of our operations for the supplier, the customer and for Wayfair in a very tangible way.

Take a coffee table's journey. First, the supplier sends the table from a facility in Asia to a port-based consolidation center, where we mix this product with many other items from various suppliers in order to build a full container load. Via this step, we optimize the mix of products headed to our various fulfillment centers and also leverage our negotiating scale vis-à-vis ocean carriers to unlock improved economics for all parties. We then ship the container with the coffee table out of Asia acting as a digital freight forwarder.

The container is then delivered from the domestic port to our fulfillment center. This step is called [ph] bridge (00:21:03), again controlled by us. We strategically position the product at a fulfillment center in our network, where the quantity will satisfy the regional demand there. Next, the item is unloaded into the fulfillment center, where we act as a third-party warehousing agent for suppliers and offer a large-scale, reliable and fast fulfillment services.

Once an order for the coffee table is placed by our customer, we take control over the last mile delivery if it qualifies as a large parcel. In this case, it is handled through our own Wayfair Delivery Network and by our own Wayfair branded teams, which are fine-tuned to drive lower damage rates, faster transit times and higher customer satisfaction. If the shipment qualifies as a small parcel delivery, we have integrated our network with common carriers for deeper last mile injection, resulting in reduced rates with third parties and offering us more flexibility [ph] and later cut-off times (00:22:02) for next-day or two-day delivery.

By playing an active role throughout the product journey, Wayfair unlocks huge benefits in cost efficiency, speed and quality, as we cut out distance traveled from the manufacturing facility to the customer's home and reduce touch points to prevent damage. We are not just doing this for a few items or a few shipments, but rather for hundreds of thousands of items and millions of shipments. To do so effectively and efficiently, we need to ensure that physical and information flows are always in sync for operational steering and customer communication.

This explains why in our supply chain, we do not just use third-party software, but build our own platforms. As a tech company, it is in our DNA to drive strong technology enablement across our operations and to capture the full potential of it. With our current operations, we already have a unique set-up in place that provides a strong value proposition for our suppliers and customers, including low cost and incidents, high reliability and speed, and end-to-end visibility. Going forward, we will focus on further improving the execution across all dimensions of our existing model.

We aim for what we call cost-efficient perfect order at scale to continue to increase customer satisfaction, growth and margin. Let's tackle each part of cost-efficient perfect orders at scale and what it actually means. The perfect

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order is one where a customer purchases a product, receives the exact item ordered within the expected timeframe incident-free and without having to contact us. More perfect orders will be enabled by enhanced supplier integration, improved post-order communication and fewer incidents.

We are developing new technology platforms to reinforce our already strong connectivity with our supplier partners and to elevate the quality of our data exchanges, such as real-time inventory feeds and predictive lead times. This level of visibility should lead to greater precision in ensuring product availability and [ph] inserting (00:24:20) delivery speed expectation. Our post-order communication will be even easier to understand [ph] consistent across the various ways we (00:24:26) reach the customer and will focus more on delivering the right message at the right time.

Cost-efficient perfect orders or perhaps better put more cost-efficient perfect orders will be driven by a comprehensive road map. Let me share three components. First is [ph] holding to the best-in-class buy (00:24:47) in our fulfillment centers. This includes improved labor planning and optimized operational processes to reduce non-value-added work, but also to improve safety. In addition, we are increasing the level of automation to drive outbound productivity and improving fulfillment center capacity through higher utilization of our existing footprint. As a result, any incremental square footage we invest in should be ROI positive even faster.

Second is improving availability, especially regional in-stock levels. This will lead to faster order to delivery times and reduced outbound shipping costs. Improving forecast accuracy and growing our share of dual and multiple fulfillment center injections are key enablers. Third, we will introduce more self-service option for customers as well as enhance existing ones. For instance, offerings like self-managed delivery scheduling will give the customer more control, while reducing contacts with our service teams.

Finally, let's talk about delivering cost-efficient perfect orders at scale. Scale refers to supporting our significant growth primarily through standardization and technology, which will help to strengthen our existing processes and also enable new services and features. For instance, we are working to expand the CastleGate self-serving offering for our suppliers and are developing proprietary technology such as Buyfair, our demand planning and forward positioning engine, which Steve talked to you about a couple of quarters ago. You should now have a better sense of some of the elements we have in mind as we scale operations to support Wayfair when it is many times the size it is today.

Now, I would like to shift gears from the future state to today's reality. Responding to the threat of COVID-19 has caused companies everywhere to operate in new ways. I would like to briefly discuss the resilience of our operations and our teams during these times. Multiple precautionary measures have now been implemented at every facility to ensure our employees and customers are safe, which remains our top priority. We rolled out temperature checks at the start of each shift and outfitted each facility with sanitizers, masks and other safety gear for our employees.

We also adjusted shift patterns, so there is no contact outside of the employees in a given shift and traceability is easier. Additional safety measures [ph] to benefit (00:27:26) both employees and our customers include contact-free delivery and a temporary halt to assembly service and room-of-choice deliveries. We are supporting our on-site front-line teams by paying a recognition bonus during this time, lifting the hourly wage by approximately 25% or $4 per hour and through more paid time off. We are also now regularly providing meals for our front-line employees and their families. This has the added benefit of supporting many of the hard-hit restaurants and small businesses in the local communities where we operate.

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In the event there are confirmed or suspect cases of infection, we have a rapid response team in place, which employs a rigorous protocol to mitigate any risk to our employees and the network. We evaluate the need to shut down the impacted facility, temporarily canceling shifts and running a deep cleaning process. Simultaneously, we use closed-circuit video footage for the affected building to identify any employees who may be at risk even despite standard social distancing protocols. In these cases, we alert them to take the appropriate steps to self-quarantine and protect themselves and their families.

The unique flexibility offered by our vast existing footprint, particularly the ability to reroute orders through other Wayfair fulfillment centers or our supplier warehouses, is pivotal in navigating through this environment. It also equips us well to respond to any future disruption as they arise. To respond to the surge in volume that we are seeing, we are now in the process of hiring more than 1,000 additional front-line workers. This is not a new undertaking for us as we are quite used to scaling these teams up and down during peak demand periods like Cyber 5 and Way Day.

Throughout, our associates are working closely with our suppliers in sharing learnings and best practices with them to reinforce their network's resiliency. This close collaboration strengthens our partnership model even further and strengthens the home goods supply chain as a whole. I'll end by saying that as various members of this leadership team and I have visited field locations all across our network over the past several weeks, we are universally impressed by the determination and spirit of our employees, and we are all very grateful of their hard work.

With that, I would like to turn the call over to Michael.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

Thank you, Thomas, and good morning, everyone. I will first briefly discuss our Q1 2020 results. As you know, our gross sales momentum accelerated in the last two weeks of March. But please recall that we only book net revenue when the order is delivered. So, much of this momentum will benefit Q2. Therefore, as you think about our financial progress in Q1, it's important to keep in mind that COVID-19 related changes are minimal in the just reported quarter and will be much more impactful in Q2.

As you saw in our press release and IR presentation, our Q1 total net revenue grew approximately 20% year-over-year with net revenues in the U.S. up 19% and International up 24%. The International net revenue growth in constant currency was higher at 26% year-over-year. Last 12 months active customers surpassed 21 million this quarter, a 29% increase year-over-year, with the share of orders from repeat customers now nearly 70% of the total mix. Other KPI metrics such as order frequency and net revenue per active customer edged up slightly year-over-year.

As I move down the P&L, please note that I will be referencing the remaining financials on a non-GAAP basis. Gross margins expanded approximately 70 basis points year-over-year and 200 basis points sequentially to 24.9%, reflecting the early cumulative benefits of the multiple initiatives Niraj described both last quarter and earlier on this call. We also saw 70 basis points of leverage year-over-year and 40 basis points of leverage sequentially in advertising as a percentage of net revenue, thanks to our efforts to drive more efficiency in our spend. In line with our original expectations, all of this work continues in Q2.

Our selling, operations, technology and G&A or OpEx expenses came in at $412 million excluding severance costs related to the February reduction in force. This was consistent with our expectation for sequentially steady dollar spend versus the fourth quarter. We are keenly focused on controlling each component of OpEx, and you

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are seeing that begin to play out. You'll recall that the primarily driver of SOTG&A is compensation expense, and we'll note that we ended Q1 with approximately 600 fewer OpEx employees, reflecting in large part the reduction in force we undertook as part of the plans put in place late last year.

Adjusted EBITDA for Q1 was a negative $127 million or negative 5.5% of net revenue. We made sequential progress in driving a lower rate of losses in both the U.S. and International segments, with adjusted EBITDA margins in the U.S. at negative 2.3% and a roughly $82 million loss in International. We ended the quarter with approximately $891 million in cash, cash equivalents and short-term investments, including $100 million that we drew from our revolving credit line. We made the drawdown as a precautionary measure, as market volatility spiked in mid-March, and have since paid back the revolver balance.

The March 31 balance does not include the proceeds from our recent convert financing. Our current cash and cash equivalent balance is approximately $1.5 billion. Non-GAAP free cash flow for the quarter was negative $355 million. As we mentioned back in February, this is consistent with the typical seasonality in our cash flows, during which first quarter outflows tend to be our largest and was made even more pronounced this year due to late Cyber 5 timing in 2019. This is also consistent with our operating cash flow seasonality with Q1 ending cash typically the low point in the year.

We believe we have an extremely strong balance sheet and can weather various forward economic scenarios. This is further bolstered by our execution, which is quickly driving company-wide profitability. Now, turning to guidance, I want to first acknowledge that establishing guidance is never an easy feat, even against the calmest of macroeconomic backdrops. As I say to you every quarter, our business is a highly dynamic one, where our predominantly mass market customer has to show up every day. This is especially true as we all navigate through today's uncharted waters.

So, what we think is most prudent to offer you at this point is twofold. First, I will offer full transparency on our gross revenue performance quarter-to-date. I will not however speculate further by providing specific guidance ranges for Q2. Second, I want to provide a framework to how to think about the progress we are making on adjusted EBITDA profitability as we execute against the plans we set in motion late last year. To be clear, this is not guidance, but instead is intended to give you a directional sense for our unit economics as they evolve outside of any COVID-19 related factors.

Let's start with what we've seen thus far in Q2 and some additional color to help frame how things might evolve. Quarter-to-date, our gross revenue growth year-over-year is trending at roughly 90%, translating to over $800 million added year-over-year on a constant currency basis. This momentum is widespread across almost all categories and includes comping over Way Day last year, which we deferred into later this year. While we do not know how long these trends will persist and thus we'll not provide a specific revenue forecast for the whole of Q2, we believe this period has certainly and permanently accelerated e-commerce adoption in our category.

We are seeing not just robust new customer acquisition, but also strong repeat trends from both long-term loyal and recently added new customers. New customer behavior and their direct feedback suggest that these customers' experience with Wayfair is leaving them very satisfied and motivated to shop again in both extraordinary times when they are quarantined and down the road when we will all be less restricted.

Shifting gears to how we are executing against our internal profitability plans, which were formulated late last year pre-COVID and are predicated on 20% revenue growth rates, our progress to-date puts us on a trajectory to achieving positive consolidated adjusted EBITDA margin in Q2 without considering the revenue acceleration we

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are currently experiencing. As our various internal work streams continue to gain traction, we would expect approximately another 100 basis points of sequential leverage on gross margin to roughly 26%.

As we continue to re-baseline and tighten our marketing efficiency targets, our plan calls for approximately more than 100 basis points of additional advertising leverage sequentially to roughly 10.5%. Finally, we would expect OpEx spend to be somewhat below $400 million in Q2, including depreciation and amortization. This is slightly lower relative to the first quarter, continuing to reflect the tighter controls we have implemented here. This is all progress that we would expect to be sustainable on a go-forward basis at 20% revenue growth rates.

From a segment perspective, given the relative maturity and size of the U.S. versus International, I'm sure you'll recognize that it is the U.S. business that will be the primary driver of delivering the profitability of the whole business. That said, in International, we are also seeing the benefits of scale and good execution against various plans to drive gains in gross margin, ad spend leverage and OpEx. Though we will not be providing more specific EBITDA guidance this quarter, as Niraj mentioned, any revenue upside in the quarter relative to how our internal plans are calibrated should flow through to the bottom line with some additional leverage on OpEx as a percent of sales, given the more fixed nature of these expenses.

Additionally, we could see more leverage to advertising as a percent of net revenue in Q2, because of competitive changes in the market due to COVID-19. To help you update your models on a few housekeeping items, please assume equity-based compensation and related tax expense of approximately $70 million to $72 million; depreciation and amortization of approximately $80 million; and 95 million in average weighted shares outstanding in Q2. Capital expenditures are expected to be roughly flat in dollar terms with Q1.

We live in a moment in time where there are too many variables to offer more specific guidance, and frankly, specific current period guidance has always seemed counter to our long-term aspirations to serve our customers, communities and employees, while delivering sustainable growth, profitability and free cash flow. I spoke last quarter about our desire and very specific execution plans to generate the unit economics to do just that. We're proud that we can be serving a rapidly growing set of customers during this unprecedented moment in time and doing so increasingly profitably as well.

Certainly, we all know we will see more macro change in the months and quarters ahead. The competitive dynamics will change. We likely will deal with a recessionary environment and there will continue to be global and domestic turmoil. But we believe we are now well-positioned to thrive regardless. We are rapidly executing on our plans to run the business profitably, while still investing for growth and serving our customers over the long-term. We have incredible brand awareness with very satisfied and engaged customers.

We have a dedicated and focused team of employees around the world. We have a deep partnership with our suppliers, and we have a very solid balance sheet. Also, we have the experience of our business in the last recession when we were able to grow each year even as the home market declined. While we do not know exactly how the world will play out, we know that times of massive change cause customers to seek new ways to purchase, and like happened in 2008 and is happening now, accelerating the movement online in many categories including home.

I'd now like to turn the call back to Niraj before we take your questions.

Niraj S. Shah

Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

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Thanks, Michael. As I conclude, I want to speak for both Steve and myself and once again thank Wayfair employees around the world for their hard work and dedication in the midst of trying and uncertain personal times. The countless ways in which you have risen to the challenge and supported each other and our many local communities make us both exceptionally proud and speak volumes to the strength of Wayfair's culture.

Now, Steve, Thomas, Michael and I will be happy to take any questions. We're doing this remotely. So, bear with us if there are any glitches.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question is going to come from the line of Peter Keith, Piper Sandler.

Peter Jacob Keith
Analyst, Piper Sandler & Co.

Q

Hey. Good morning, everyone, and thanks for all the details on today's call. Obviously, with everything that's going on, it's fairly exciting what you're seeing in your business. One question I've had is just on constraints to the growth. We have heard from the channel that there's out-of-stock issues, even maybe some capacity constraints with your third-party deliverers of small parcel. So, 90% growth, obviously, quarter-to-date impressive, but is that being hindered at all by any inventory or delivery constraints, because certainly that's not a number that you guys had planned for two months ago?

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

A

Hi, Peter. It's Niraj. Well, thank you. Thank you for the comments and the questions. To answer them, so first in terms of constraints to the growth, the way I would describe it is that we're actually incredibly well-positioned to handle this type of unanticipated surge. And the reason is a few-fold. First, to your first question about inventory, if you think about our platform, we work with 10,000-plus suppliers who are all listing the wide range of products they have and the inventory they have available. So, in this particular situation, you could have a small number of them, who perhaps specialize in e-commerce, who see unprecedented volume and they have some shortages.

But there'll be quite a few who work across multiple different channels and they'll see their brick-and-mortar business be slow and their other channels perhaps not moving as fast. So, their inventory availability will flex up in a way that they didn't anticipate, and it could be in puts and takes, countries of origin, so on and so forth. The net is we have availability across all of that inventory. So, we're a beneficiary. We're able to keep items broadly in-stock. And just remember, we have 10,000-plus table lamps. And so, inventory on a particular individual one might get hampered. But overall, the breadth of availability we have right now is better than it normally would be, simply because what's happening is demand in a lot of channels is off.

On the second question about logistics capacity, there's no question that this type of surge, which is a kind of peak holiday surge that is still unabated, that's continuing day after day and week after week, is not something that just – you can just turn on. We're seeing the carriers we work with doing incredible things to flex up their capacity. But again, we're advantaged because if you think of our 15 million square feet of logistics capacity across 65 buildings, in a lot of that capacity, we're not just storing goods and tendering them to a small parcel carrier for their local store. We also do a lot of sortation in our buildings, allowing us to run direct injection lanes. And as we get more volume, we can dynamically turn on additional lanes.

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What this does is it obviates some of the constrained spots in the carrier networks, allowing us to take advantage of the ability to inject volume that they couldn't otherwise have. And so, long story short, it's not easy to necessarily handle a surge and you're plus 90% when you didn't plan for it. But our operations team have done an incredible job of bobbing and flexing. Our suppliers have done an incredible job, the way in which our team who run all our buildings have done just an incredible job on safety as well as handling the capacity, and as a result, we have not been constrained.

Peter Jacob Keith
Analyst, Piper Sandler & Co.

Q

Okay. That's very interesting and helpful. I guess I could ask a bunch of different questions, but maybe focusing on gross margin, because it was impressive in Q1, will be more impressive in Q2. Can you maybe just highlight some of the key drivers that you're seeing right now for that year-on-year improvement?

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

A

Yeah. So, I think the most important thing to just remember about gross margin, because we've been talking about this for years, the range we've been in for a long time, which was about 300 basis points away from the range that we've guided to in our long-term model, and we've always cited multiple levers that could close the entire gap. We said that suppliers flexing into our platform could close the entire gap. We said that logistics efficiencies based on the logistics network we're building and reducing damage, reducing shipping costs could close the entire gap.

And we said that what we were doing on merchandising investments with the red carpet merchandising and the house brands and a growing percentage of these items being exclusive vis-à-vis some of our competitors could close the entire gap. And then, we added a fourth pillar, which is supplier services. So, that's CastleGate and Wayfair Sponsored Products. And that's early on, but that's another very large one. And so, we have multiple levers that could each close a few hundred point gap. And so, if you think about that, if the gap is 300 basis points and you have multiple leavers, you're talking about 1,000 basis points of theoretical potential. We've been investing against that in years.

And so, we're now at a point where we can start to harness some of those gains. And so, what you're seeing with the step-up in this past quarter and the guidance Michael gave, you just see us starting to harness the gains. And some of these are short-cycle gains, and then there will be additional ones long-cycle. And so, the gross margin trajectory which we've talked about, you're just seeing it start to manifest in the P&L. And so, this is – again, this is not really COVID-related. This is more part of that multi-year strategy we've had in investing into these things that will manifest as gross margin gains, you're now seeing it show up.

Peter Jacob Keith
Analyst, Piper Sandler & Co.

Q

All right, great. Thank you very much and good luck.

Operator: Thank you. Our next question will come from the line of Chuck Grom, Gordon Haskett.

Chuck Grom
Analyst, Gordon Haskett Research Advisors

Q

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Hi. Thanks. Good morning. Hope everyone is doing well. Just wondered if you guys could speak to how your basket composition has evolved over the past six weeks in terms of exactly what consumers have been purchasing from you. And then, Michael, is there a way to think about the flow-through on the better direct revenue trends? You've stated that you expect positive EBITDA even with pre-COVID sales levels. Quarter-to-date up 90%, but just is there a way to think about the flow-through? Thank you.

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

A

Chuck, this is Niraj. Let me answer the first question, and then I'll turn it over to Michael. On the first question, in terms of basket composition, what I would say is if you think about the seven-week period now, the first couple of weeks in kind of mid to late March, there were certain categories that accelerated first. And these are ones you'd associate with staying at home and working at home and the kids being at home, home office – and cooking at home, home office, kitchen, large appliances, small electrics, storage and organization, children's playroom, children's furniture, outdoor recreation. But what we saw during that period is we saw then it start to spread pretty widely. So, the outdoor category started to take off. The décor category started to take off. The renovation category started to take off. So, really the concentration in growth is not anywhere specific. In fact, it is very broad-based, and that's what we're seeing.

So, I wouldn't – if you look at what's happening right now, there is no concentration in certain categories. And frankly, you don't really see categories being left behind either. I'm going to let Michael answer your question on flow-through. But the one point I just want to make on that before I turn it over to Michael is just we're running the business around a plan to be sustainably profitable at a growth rate we were already at pre the COVID crisis. And so, if you just think about the investments, these have been multiple year investments, and if you think about the parts that we accelerated, they go back to a plan that we honed in November of last year, six months ago. And that's why you've seen step-ups in Q1 in different actions we took in Q1, and you're seeing additional in the guidance for Q2. It's not really specific to COVID. But in terms of the flow-through, I'll let Michael answer how that can manifest.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

Thanks, Niraj. Thanks, Chuck, for the question. I think what we tried to highlight in the prepared remarks is you can think about OpEx costs for the quarter as basically fixed, right. So, incremental is going to flow through that completely. I think from a gross margin ad spend perspective, we noted that in ad spend, the COVID situation may drive incremental leverage on ad spend, but we'll see how the rest of the quarter plays out. And I think the gross margin, you can think about as the gross margin as Niraj just mentioned that we've been sort of making all these investments in for a long time and starting to see the flow-through of that. So, I think you should be able to continue to see these kind of gross margin levels that I noted on the call, the 26%, as sort of flow-through from incremental revenue as well.

Chuck Grom
Analyst, Gordon Haskett Research Advisors

Q

Okay. That's helpful. And then, just as a follow-up, when you look at the cost components in your P&L, gross margin, advertising, OpEx, how would you force rank the greatest areas of opportunity to get to that 8% to 10% long-term target that you guys have been talking to for a number of years?

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

A

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This is Niraj. So, let me just make a couple of quick comments, and then Michael can chime in [ph] I think if he has additional (00:52:11). I think the key thing is to think of it [ph] as an and (00:52:15). So, we – and in the long-term [ph] models, we try to (00:52:17) highlight that. But basically, going from the bottom-up, OpEx is – we already have in the OpEx cost number a huge amount of investments into the future. So, we're not doing anything around cutting our long-term investments, but rather the thousands of people we added, they're working on those things. We just don't need to add additionally to actually drive significant progress. So, that's just as revenue grows, you see the OpEx lever, and that's where we are right now.

Ad cost, we talked a lot about our attribution technology and ways we're driving efficiency there. In fact, that gets benefit as repeat grows as a percentage of the total. The repeat revenue actually runs at a very low ad cost. And then, gross margin, I just talked about that a minute ago. There obviously is a huge runway there. So, if you're saying which one is the largest of the three, it would be gross margin. It's also the biggest number of the three and has the most levers of the three. So, rather than focus on that being the biggest, I just think of this as [ph] an and (00:53:09) where you should see gains are everywhere. And Michael, do you – anything you wanted to add, Michael?

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.
A

No, I think you covered it well.

Operator: Thank you. Our next question will come from the line of John Blackledge, Cowen.

John Blackledge
Analyst, Cowen and Company
Q

Thank you. On the demand environment, I recognize the situation is fluid. But as we round towards second half, maybe Niraj or Michael, how are you thinking about kind of the puts and takes of the demand environment, just given the current demand surge and then US slowly reopening, coupled with a looming bad macro, given the job losses, and then maybe alongside potential fears that people have going into retail stores? So, just any – it's like kind of crystal ball, but any – there's a lot of puts and takes. Just curious how you guys are thinking about it. And then, I just have – on the gross margin, my other question would be, you guys have said 25% to 27% longer term. But I think Niraj cited a lot of levers. So, like when we think longer term, could it be even above that 25% to 27%? Thank you.

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.
A

Thanks, John. And I'm just going to do them in reverse order. I'll let Michael chime in at the end. On gross margin, just keep in mind, as we unlock benefits in gross margin, we have a choice with what to do with those gains. We can take it into profit, which then gives us cash flow that we can invest in the future, whether we return it to shareholders or we buy back the stock or we invest into something new or what have you. And if we invest into customers, we can lower retail prices or we can make service quality better or we can do things that cause us to get more lifetime value at improving unit economics that creates future cash flows. And so, there are different things you can do as you unlock these levers. And some would grow the gross margin percentage and some wouldn't, but all of which would actually accrue to our financial benefit long-term. But I'll let Michael comment on that in a second.

But let me go back to your macro question. So, I think the sentence you said in there sums it up the best, which is there are a lot of puts and takes. But I guess what I would leave you with is a few key things. One is what we're

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seeing right now is not really that competition has been abating. We actually see the online competition remaining significant. But what we are seeing is a huge secular shift from offline to online. And there's no question, part of it is temporary, but we do think part of it is permanent. The temporary – obviously, stores will not remain closed. But as stores reopen, for some period of time, people might be hesitant to go. But frankly even when they're not hesitant to go, what we've seen is millions of customer who had not been previous online shoppers in the category to come online and buy.

And what we're seeing from their Net Promoter Scores and their repeat behavior, we think they've been very pleasantly surprised with the selection and the convenience. And we think that a portion of their spend in the future will remain online. We don't think that this is going to revert back to the secular transition that was underway before, but we think it's accelerated it to some degree. So, we think that's a significant beneficiary. The other thing I would say is it is – discretionary money can be spent in a number of areas, and home goods is certainly one area and fashion would be another area, but there's other areas as well. Taking a trip, an airplane ticket and a hotel room, or going out to eat or going to a concert or a sports game.

And so, what I think is happening right now is you're seeing a few different things. There's just not just a shift online that is going to be accelerated through this, even if the absolute percentage online drops back a little bit. But you're also seeing that home is becoming a area that customers are disproportionately investing into right now. And I would expect that to persist for a while. After 9/11, which was, I would say, not as big a persistent long duration shock as this is proving to be, there was actually a multiyear tailwind into home improvement and home spending that was unlocked through that. I believe that that's going to happen here.

And so, I think we're going to have a bad economy to your point. We tend to outperform in a bad economy, because the wholesale cost, the transportation cost, the advertising cost, all get better for us and we can provide more value to customers. And then, you've got a bunch of trends that actually favor online and favor home. So, I think on net, we're pretty optimistic about how things will work. But again, the plan around profitability is predicated on quite a low growth rate. But I do think there's a lot of reasons why the growth is actually going to stay quite strong. Michael, anything you had on the question?

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

The only thing I'd add, John, on the long-term targets, obviously, we set those long-term targets in place five-plus years ago. And since then, we've made a huge set of investments around some initiatives, you think about what we've built in logistics as an example, that are going to drive – that have the potential to drive huge opportunity in unlocking gross margin. And obviously, when we set those targets five years ago and put them in place, we didn't know what the investments were going to look like or what the world was going to look like today. And so, I do think there's – I think there's upside throughout the P&L as we sort of start to see all the investments we've made over the last few years bear fruit over the coming years.

Operator: And our next question is going to come from the line of Justin Post, Bank of America Merrill Lynch.

Justin Post
Analyst, Bank of America Merrill Lynch

Q

Great. Thanks for taking my question. Interesting that you have 90% surge. Can you just tell us how the warehouses are holding up with that kind of surge and how you could possibly be prepared for that kind of volume uptick? Impressive to be able to handle that. And then secondly, I think your number one online competitor, Amazon, might be focusing more on consumables right now. Can you talk about progress you might be making in

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the category with your suppliers right now and how you can kind of maintain those relationships and really help you over the long-term? Thank you.

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.
A

Thanks, Justin. Let me answer the two. So, in terms of the warehouses, one of the things that's important to remember is our network is somewhat different than some other e-commerce optimized networks. First of all, there's only a few large-scale e-commerce optimized networks. Ours is optimized for home goods. And in home goods, you find there's a huge selection [ph] parade (00:59:33), and there's clearly items that ship out of our buildings and then there are items that we ship from our suppliers, because there's quite a long tail. Unlike AA batteries, where everyone is buying the same exact items as each other, the Duracell or Energizer, the 9-pack or the 18-pack or maybe the house brand, here there's actually 10,000 table lamps and there's quite a spread.

So, what we do is we have a portion of the volume that comes out of our buildings, and that's around about 30% of the volume, and then we have a portion, about 70% of the volume that ships from the suppliers' warehouses. The 10,000-plus suppliers have warehouses and then they're all shipping. And as you can imagine, their volumes in aggregate are – their other channels have slowed down. So, they have capacity. And then, what we've done is we flexed that capacity. Thomas mentioned we added over 1,000 people. We've moved to multiple shifts. And so, we've done a bunch of things that allow us to take on more volume. And then frankly, a lot of what we do is sortation. There's other things we do that add benefit. So, while we couldn't anticipate the surge, I think our model and the flexible nature of our model lets us lean in better.

In terms of the question about competition, Amazon, we think Amazon's probably seen a spike in consumables. They're certainly oriented around that, and they are one of our competitors for sure. I'll just remind you, we do have quite a few competitors though that we compete with, and I've just seen some of the reports about some of the brick-and-mortar stores that they've been doubling their e-commerce business. [ph] They go from (01:01:08) 10% of their volume to 20% and what have you. But there's a lot of different competition out there. So, we're pretty happy with our performance, but it is a competitive landscape.

That said, your point about suppliers is an important point. I think we've long since had some of the strongest supplier relationships out there, and what we're seeing is that this is only having suppliers lean in even more, because they believe that e-commerce was really fundamentally their only growing channel and a lot of their other channels were going to slow over time. But this is sort of putting a point on it, and we're seeing them flex in. And I think they view our platform as an ideal one for home, because their goal is not to commoditize their offering. Their goal really is to have that breadth and have it well-merchandised and reach the customers with a home-type focus, and we're able to provide that. And so, we've had gaining momentum with suppliers as the years have gone by, and we've certainly seen this kind of continue to further accelerate that.

Justin Post
Analyst, Bank of America Merrill Lynch
Q

Great. Thank you.

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.
A

Yeah. Thanks, Justin. And Thomas, I just didn't know if you wanted to add anything about any of the logistics operations, how we've been able to flex up, because that question came up a couple of times. I thought maybe – anything you want to add?

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Thomas Netzer

Chief Operating Officer, Wayfair, Inc.

A

No, I can only echo what you said, Niraj. I think the one thing which we benefit from is obviously our unique set-up, as you rightly laid out, given that we can [ph] fulfill them (01:02:28) from our own warehouses and we leverage our drop-ship suppliers. But I think the other thing which is important to note is that when we think about the current growth and how to deal with it, it is less a matter of storage in our warehouses. It's much more a matter of throughput.

For storage, we have actually made significant investments over the last years. So, that's why we have more than 10 million of square footage available. And when it comes to throughput, we have the ability and also the experience to flex up and down our workforce. And this is what we are currently doing. We just put more people into our warehouses, which then have the throughput capacity to [ph] fulfill the current scope (01:03:04), and therefore, we are not struggling right now. We are rather in a very comfortable position to still fulfill the orders the customer places.

Operator: Thank you. That concludes the Q&A portion of today's conference call. I'll turn the call over to Niraj Shah for closing comments.

Niraj S. Shah

Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

Hey, everybody. We just want to thank you for dialing in today. And we just – the 16,000 people here at Wayfair are really proud of how we've been able to help the community, help each other and take care of our customers, and we couldn't be more proud of how things are developing. And thank you for your interest in the company.

Operator: Thank you. Once again, we'd like to thank you for participating on today's conference call. You may now disconnect your lines. Thank you.

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