

05-Aug-2020

Wayfair, Inc. (W)

Q2 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by and welcome to Wayfair Q2 2020 Earnings Release and Conference Call. At this time, participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions]

I would now like to turn the conference call over to Jane Gelfand, Head of Investor Relations and Special Projects.

Jane Gelfand

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

Good morning and thank you for joining us. Today, we will review our second quarter 2020 results. With me are Niraj Shah, Co-Founder, Chief Executive Officer and Co-Chairman; Steve Conine, Co-Founder and Co-Chairman; and Michael Fleisher, Chief Financial 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 third 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 include measures such as adjusted EBITDA and free cash flow. 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 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. I'm glad to be speaking with all of you and hope that you are safe and well. Q2 2020 was a very strong quarter for Wayfair as COVID demand tailwinds benefited our sales momentum. More significant is that these circumstances highlighted the attractiveness of Wayfair's value proposition to our customers, the solid foundation we have built over multiple years, and the early fruits from the plans we put in motion last year to drive tighter execution and efficiency gains.

Q2 demonstrated that Wayfair's now a meaningful, well recognized, and trusted household brand. Millions of customers, new and loyal, are seeking us out when their attention is on their homes. They're turning to Wayfair as they explore how to use their homes in new ways and seek comfort in them during highly uncertain times. Q2 demonstrated the wisdom of our strategic investments and the returns that they can generate. Our proprietary logistics network allowed us to effectively meet peak demand not just for a few days or a three week holiday stretch, but consistently over the course of a full quarter.

The wide spectrum of product classes we have seeded over this last several years positioned us to capture an outsized share of increased category demand. And our robust local operations and offerings in the UK and Germany forged the way for strong customer acquisition in Europe as demand there also shifted online.

Finally, Q2 demonstrated the uniqueness of Wayfair's culture. Our more than 16,000 employees persevered despite the challenges of the moment. Our team demonstrated enormous agility, productivity, and strength of execution and stepped up to serve our customers when they needed us most. Combined, all of these elements led to a turning point in our profitability. Even against the normalized demand picture, we fully expected to inflect positively in adjusted EBITDA in Q2. But what played out in this quarter was exceptional. We delivered \$440 million in adjusted EBITDA at a 10.2% margin and over \$1 billion in free cash flow. These results demonstrate the inherent strong structural profitability of our platform.

While we are pleased with our financial results in Q2, we are most proud of how Wayfair has continued to support our employees, our customers, and our communities in the midst of the pandemic and pressing social issues. We remain vigilant when it comes to health and safety and continue to build on and enhance the host of safety measures we first implemented in March to keep our employees and customers as protected as possible.

We are maintaining our Dinner to Go program on the front lines, which provides meals twice a week to our logistics employees and their families, while also supporting local independently-owned restaurants in the many communities where we operate. And we stepped up our charitable efforts this quarter with several million dollars donated to both COVID relief and social justice organizations. Internally, as part of our ongoing diversity, equity, and inclusion work, we launched a companywide discussion series to bring greater visibility and understanding to the perspectives of Wayfair's diverse employee base. While early in these efforts, the discussions are a step in helping us to collectively address the multi-faceted issues that many of our employees contend with every day.

I would like now to turn to some observations about customer behavior and category momentum during the second quarter. While it's difficult to pinpoint precisely, we believe the home goods category in total remained relatively resilient over the last several months. Consumers deprioritized expenses such as travel and entertainment and shifted their focus and discretionary spending to their homes. We see evidence of this in strong and consistent demand across nearly all of the product classes we sell, not just those directly linked to having to shelter or work from home. Accelerated e-commerce adoption was also an important tailwind in Q2 and should bring longer lasting benefits to our business.

What was, even before COVID, an inextricable shift to e-commerce then became supercharged over the last several months, and we believe much of the step change in online penetration will prove to be sticky. In fact, our view is that e-commerce adoption is likely to continue to shift faster than it did pre-COVID. Just to put things into perspective, in the quarter we activated nearly 5 million net new customers, more than the last four quarters combined. In the US, we also reengaged more than 1 million past customers who had been absent from the platform for longer than 12 months. Whether B2C or B2B or new or last, these customers discovered why shopping at Wayfair can be a superior experience to shopping at brick-and-mortar and how our selection, merchandising, service, and delivery are constantly improving to make finding the perfect product for your home easier and more enjoyable.

Also unique to this quarter was the relative magnitude of the strength of both new and repeat customer activity. In a typical quarter, order growth from our repeat customers tends to considerably outpace our strong order growth for new customers. In Q2, despite the fact that repeat orders more than doubled year-over-year, new customer orders grew even faster. This is the first quarter that this dynamic has played out since Wayfair's IPO in 2014.

The behavior of these customers activated during the COVID era continues to suggest that they are a high-quality set who will choose Wayfair again and again. As you know, we are a highly data-driven and analytical organization, so we're keeping a close eye on newly acquired customers for any behavior differences relative to pre-COVID cohorts. Our observations tell us that this new cohort of customers is reengaging with our platform at higher than usual rates after their initial purchase and that this engagement is translating into higher-than-average repeat order rates. In Q2, we also saw a slightly different cadence to our customers order patterns with fewer items per order offset by higher purchase frequency. Shopping via mobile platforms, including our apps which saw heavy download activity, were about 600 basis points sequentially in Q2 to over 60% of all orders.

It would be overreaching to predict what exactly will play out in the coming weeks and quarters. There's a tremendous amount of macro uncertainty and various pressures on the consumer. This is coupled with clearly changing behavior in terms of what consumers are buying and how. That said, what we have seen thus far would suggest that even as economies reopen, our customers remain focused on the home and are extremely satisfied with Wayfair. In those markets where reopenings thus far have proceeded pretty smoothly, we're seeing some moderation in our rates of growth relative to Q2. But even in those instances, we are still experiencing strong momentum well above the top-line growth rates Wayfair was seeing at the start of 2020. While COVID-related tailwinds are still undoubtedly a strong contributing force, recall that late last year we put in place a number of internal changes which are now translating into tighter execution across the business and an enhanced customer experience. We believe these improvements are also showing through in our top line momentum and should bear long-lasting benefits well beyond the COVID period.

I want to take a step back now to acknowledge the herculean task of what responding to such unprecedented demand has meant to our team. In a normal year, Wayfair experiences two seasonal peaks with Way Day, typically in the spring and Cyber 5 going into the holidays. There are, of course, other promotions and events happening all year, but these two major events require months of advanced planning and coordination, both

cross-functionally inside Wayfair and in collaboration with our supplier partners. Since approximately mid-March, nearly every day has rivaled those cyclical peaks. Simply put, we could not have effectively met over \$4 billion of demand as we did in Q2 without the kinds of infrastructure, technology, and relationships we've invested in over many years. And while not everything can be operationally perfect under such extreme conditions, we're also internalizing our learnings and adjusting our practices very quickly to address any stress points that reveal themselves.

Let me elaborate. Across our CastleGate Fulfillment network, the sheer volume of products moved in Q2 nearly doubled year-over-year. Recall that over the last two years, we added approximately 40 buildings and more than doubled the square footage across our logistics footprint to over 16 million square feet. As a result, we are fortunate to add capacity in many places to flex in response to the wave of demand and we saw enhanced efficiencies as a result. Where capacity was tight, we took advantage of the hybrid model we have in place and leaned on our suppliers' logistics solutions when appropriate. The work we had started pre-COVID to build additional racking and automation across our CastleGate locations served us well during this period and we continue to move quickly against our pre-planned CapEx projects to unlock additional capacity. We did so while bringing on more frontline staff and implementing many safety measures to keep our team safe.

Due to unprecedented e-commerce demand in general, we could not fully avoid the shipping congestion and longer delivery times all carriers faced in Q2. However, we were able to mitigate some of the inconvenience within our own Wayfair Delivery Network, through which most of our large parcel orders travel. Within customer service, we are now onboarding 1,000 additional members onto our service team to bolster the customer experience. We pride ourselves on delivering the highest quality customer service in the home goods space, and our employees have worked literally around-the-clock to satisfy the higher volume of calls and emails during this time. Customer inquiries are elevated as a function of greater order volume in general but shipping congestion and related delays are also contributing. Despite this, customer satisfaction remains high and service levels are now improving as we bring on more associates to help our customers.

Nowhere was the strength of our model and ability to be agile more evident than in how we worked with our suppliers over the course of the quarter. We believe that we will emerge from this experience an even stronger and more strategic partner to each of our suppliers. And Steve will speak to this in greater detail in just a few minutes.

While working together to navigate quickly changing regulations, we aided suppliers in pivoting hard as store closures mounted. And through nearly constant communication, together we were able to demand, plan and optimize the flow of product to the customer. In the process, we demonstrated once again how suppliers are truly a part of the Wayfair family and how differentiated our approach is relative to more traditional supplier retailer relationships.

Shifting gears to profitability. I want to go back to a phrase I used last quarter to describe where we are today. Wayfair is now large enough and strong enough to both be profitable and to continue to invest with a long-term horizon. Several years ago, we simultaneously pushed forward with our three large strategic investments. Even when we were a much smaller company, we knew that these would, together and individually, be game changers, with high ROIs, which meant plowing back every profit dollar and also leaning on external financing to back these. Today, at \$11.5 billion in net revenue over the last 12 months, our conviction in these projects remains as high as ever and we continue to fund them with enthusiasm. The difference, of course, is that there are many more contribution profit dollars being generated today relative to a few years ago, and so increasingly, they are flowing to the bottom line.

As our strong sales momentum continues, the inherent profitability of our platform will become increasingly apparent. Q2 profitability inflection occurred fully in line with what we expected would happen when we started the year, though admittedly, the strength of the quarter made the inflection much more powerful than even our ambitious plans had envisioned. I want to briefly highlight a few of the many levers that contributed to the exceptional leverage across the various P&L lines in Q2. While the magnitude of the benefits we derived from each of these in Q2 is likely to moderate as revenue momentum normalizes, the underlying drivers behind the efficiencies remain structurally in place. To be clear, we expect to continue delivering positive adjusted EBITDA margins on a go-forward basis, assuming 20% or higher net revenue growth rates.

Within gross margin, we've often talked about four primary levers. One, the benefits of scale and how that can drive more robust competition on our platform; two, logistic savings as our network becomes more fully utilized and as we expand the capabilities within it; three, merchandising in house brands as a means to drive loyalty and pricing flexibility; and four, the advent and growth of supplier services. We saw progress on all four dimensions this past quarter. We drove gains in assortment as many suppliers leaned in on e-commerce, in general and our platform, in particular. We gained access to full catalogs and built wider product selection across many classes. Via our partner home platform, we also moved to leverage more data and technology to inform supplier decision making when setting wholesale costs, thus unlocking some benefit in the process.

Across CastleGate, WDN, we saw a slew of wins as a function of the elevated throughputs. Even while absorbing extra expense to upgrade the safety standards of our logistics operations in light of COVID, we saw gains via fulfillment labor efficiency within CastleGate, stops per route increases within WDN, and optimized routing yielding savings, even when drop-shipping product.

We made further progress against the body of empirical work we started last year, showing that customers choose and stay with Wayfair because of the superior overall experience we offer them and not because of any specific product or promotional event. This is a milestone built on the back of several years of major investment, particularly in elements like red carpet merchandising and our differentiated house brands. The findings have also opened the door to more refined promotional and everyday pricing strategies.

Finally, and perhaps not overly surprising, the supplier services, such as sponsored listings, grew quite strongly in this environment, particularly as suppliers shifted more of their resources away from brick-and-mortar and traditional trade ship formats and focused their attention on winning in an e-commerce segment.

We believe we have a long runway of gross margin gains ahead of us as we continue to invest and reap the benefits from these efforts. Q2 spoke clearly to this potential. Q2 was also a powerful illustration of our marketing model at work. During the quarter, we reached the tighter efficiency targets we established across all of our channels earlier this year. This was consistent with the timeline we set for ourselves, given moving to these targets is an iterative process and it was in a highly dynamic market.

In Q2, as always, we empowered our channel marketers to invest in long-term growth and customer acquisition, as long as those decisions met the refined payback targets. Even as our teams took advantage of unique opportunities across pay channels, which were driven by strong ROI from lower media costs and high customer velocity, we drove significant leverage year-over-year in advertising as a percentage of sales. While we are pleased with the financial results, we are most excited about the influx of first-time online shoppers and look forward to building long-lasting relationships with many of these new Wayfair customers.

Let me now touch upon the corporate head count as the primary driver of our OpEx line, which also saw meaningful leverage in Q2. We are nearly six months into having slowed our hiring after an intense two years of

growing our ranks and earlier this year, eliminating some roles. The intent of both of these moves was to strengthen day-to-day execution by allowing our teams to mature and to accelerate our progress against our most important initiatives. During our biannual business review cycle this spring, the executive leadership team was encouraged to see these goals clearly playing out. Over the last two years, we hired many people to focus on multi-year initiatives based on our long-term orientation. And I'm excited that we have kept that orientation even as we have tightened execution. As a result, we believe that our original plan to keep our OpEx head count flat to down for the year relative to 2019 levels, is appropriate. Despite the exceptional momentum we have experienced.

Those of you who have followed Wayfair for a while and know us well understand that we do not manage this business in quarters, but think forward in years and decades. Through that lens, Q2 is significant to us not because of the strength of this period's financial results, but instead, because of the opportunities it presented. We served new and existing customers as they faced off against precarious circumstances. We increasingly built strong relationships with each of them as well as our many supplier partners. And in the process, we are leveraging the strategic investments we've made with a much longer-term future in mind. We do not know what tomorrow will bring, but we are confident that Wayfair is stronger today than it has ever been and that we will emerge even stronger on the other end of these uncertain times.

We have firm control of our business levers, the unique capability to be both a quickly-growing and profitable company, and a significantly bolstered balance sheet to usher us through a volatile market environment. Though, we remain focused on our long-term vision and goals, we're ready to seize whatever opportunities come next.

And with that, I'll turn it over to Steve.

Steven K. Conine

Co-Chairman and Co-Founder, Wayfair, Inc.

Thanks Niraj. I want to take this time to share some insight on how this complex COVID period has further enhanced our already close alliance with our 12,000 plus suppliers. I will also provide an update on the inventory picture. At the onset of the pandemic in the US and across Europe, suppliers were faced with a combination of challenges. They were overwhelmed by quickly-changing rules and regulations on how and if they could operate. They were in the middle of managing inventory tightness caused by reduced China production and they faced the prospect of an inventory glut as physical retailers began to close and cancel orders.

As we often say, our success depends on supplier success and we mobilized quickly to help each of them make sense of the complex circumstances. Our teams kicked off a series of intense rounds of communication, sharing real time guidance that enabled our suppliers to remain open and operational, as we quickly implemented a myriad of safety measures to keep our front line workers and customers safe, we shared these best practices with supplier partners as they grappled with the same within their own warehouses and networks. Where these protocols were too much to take on for less skilled players, we leaned in with CastleGate and WDN as solutions and successfully brought on more participating suppliers during the second quarter.

This intense initial communication went on to set a standard for how closely aligned Wayfair has remained with supplier sense. In particular, we've elevated the frequency and quality of forecasting and supply coordination in a meaningful way. This includes going deeper to understand the health of everyone's supply chain and to gain visibility into production pipelines so that we can better piece together what is needed to fulfill immediate demand. Such improvements help give our suppliers, many of whom are understandably nervous, the confidence to keep ordering in uncertain times and to direct that product our way. To do so, we began to signal to our suppliers what this opportunity would represent for the online channel and why Wayfair was uniquely positioned to take share

and to power their growth. We complimented that by moving to a biweekly forecasting model and through sharing a lot of detail. We supplied both macro- and micro-intelligence including class and state-by-state level perspectives as well as the underlying assumptions behind our forecasts.

Niraj, Michael, and I along with the broader team, were highly visible throughout with regular email updates about the state of our business, as well as a variety of virtual meeting forums. We remain so today. Our suppliers feel supported by our approach and foresight and the feedback to our outreach has been overwhelmingly positive.

Speaking of virtual meetings, it has been fascinating to watch our industry's trade show model go digital. While the vibrancy of physical trade shows is impossible to replicate and we all look forward to returning to the trade show floors, we have maximized the benefits of virtual events in the interim. We are maintaining the same cadence of trade shows as usual, even while working from home, dedicating more time to one-on-one meetings without the typical distractions and are able to see more suppliers at these events. By facilitating more high-level executive connections and offering more robust data and transparency at an especially dynamic time, we believe Wayfair has taken greater mind share in the virtual trade show format.

Turning now to the inventory outlook. It is perhaps not surprising that we and the industry operated with higher-than-usual out of stocks across a narrow set of categories in Q2. The out of stocks were most acute in late spring and early summer. The good news today is threefold. First, we find that substitutability remains high. The benefits of having a vast product assortment as Wayfair does, has never been more pronounced. As a result, we do not believe that meaningful revenue is lost due to lighter than usual inventory levels.

Second, product availability restrictions are easing. The combination of COVID-related shutdowns in China early in the year and the elevated demand that began in late March led to undeniable tight supply in Q2. Some classes in outdoor, such as trampolines and products such as freezers were basically out of stock, but because we engaged quickly with our suppliers to build extra confidence in our demand projections, they began reordering in greater numbers as early as April. This means that new product is now arriving in North America and in Europe. This is obviously key as some geographies are moving backwards on reopenings and it is becoming increasingly clear that we will not be rid of the virus for some time.

Finally, even inventory challenges breed interesting opportunities. As we work with suppliers to circumvent these issues, we on-boarded and forged new relationships, increased visibility into our partner supply chains, and built more flexibility and connectivity between CastleGate and their respective networks to get product to our customers as quickly as possible.

We have always said that our model should be a win-win-win for customers, suppliers, and for Wayfair. This recent period is a clear illustration of this credo at work. When it comes to suppliers, the more sophisticated conversations and practices we developed during this extraordinary time have made us smarter about each other's businesses in ways that will serve us well beyond the immediate moment.

I'll now turn the call over to Michael to discuss our Q2 financials and how we are thinking about Q3.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

Thank you, Steve, and, good morning, everyone. Let's first turn to the substance of the just-reported Q2 results. As you saw in our press release and IR presentation, our Q2 total net revenue grew approximately 84%, or \$2 billion year-over-year. Net revenues in the US grew 83%, and international grew 91%. International net revenue growth on a constant currency basis was higher, at 97% year-over-year. You might be wondering why our net

revenue growth rate in the quarter fell somewhat below the 90% plus gross revenue growth rate we quoted in our interquarter investor conversations. As you know, we measure gross revenue on a when-ordered basis, while net revenue is booked upon order delivery.

So, the wider than usual gap between gross and net revenue growth rate in the quarter is primarily explained by delivery timing. With longer lead times in certain classes of goods and shipping congestion still a reality, some revenue essentially shifted out of Q2 and into the third quarter. We expect some of these delivery delays to persist through the third quarter.

Because Niraj earlier discussed many of the key KPIs we track, I'll jump directly to gross margin. As I move down the P&L, please note that I will be referencing the remaining financials on a non-GAAP basis, which includes depreciation and amortization but excludes stock-based compensation. Gross margin came in at 30.7%. This is a standout result.

You'll recall that when we laid out for you back in May what our margin expansion plans would have been in a 20% growth environment, the gross margin assumption had a more moderate expansion baked in, to get us to approximately 26%. There were multiple puts and takes that played out in reality in Q2. We absorbed nearly \$15 million in incremental COVID-related expenses but we also benefited meaningfully from increased volume throughput and related efficiencies across our logistics footprint, some of which Niraj highlighted earlier. Also, a less intense promotional environment in Q2, promotion and pricing benefits from our merchandising and house brands efforts, and a faster than anticipated ramp in supplier services this period, also contributed to the upside versus our ex-COVID plans. Customer service and merchant fees contracted by about 50 basis points as a percentage of net revenue both on a year-over-year and sequential basis. While this is a largely variable line item, there is some lag between our ability to flex and appropriately calibrate our customer service levels vis-a-vis the rate of revenue growth. We expect this to normalize some going forward.

Moving onto advertising. We saw 140 basis points of leverage year-over-year and 210 basis points of leverage sequentially. Our plans called for substantial leverage in the second quarter, even in a lower revenue growth environment, reflecting primarily the move to tighter efficiency targets across all channels which we initiated at the start of the year. This played out as expected in lower media costs and higher conversion rates, particularly early in the quarter, also drove some additional upside. This happened even as our marketers took full advantage of the attractive customer acquisition opportunities the market presented.

Our selling, operations technology, and G&A or OpEx expenses, came in at \$395 million. Niraj already spent some time talking about the head count considerations that serve as the primary driver to this line, so, I'll just say that I'm pleased with the discipline we're demonstrating on this front as well as in the other elements of OpEx and by the strong expense leverage we're seeing as a result. Adjusted EBITDA for Q2 was \$440 million, or 10.2% of net revenue. The confluence of unique top-line momentum, strong efficiencies linked to this volume growth, and our structural work to drive increased profitability contributed to this powerful inflection. In the US, adjusted EBITDA margin equaled 11.9%, and for the first time we also saw positive quarterly adjusted EBITDA in the international segment, at \$5 million.

I want to briefly zoom in on non-GAAP diluted EPS, which was also strongly positive at \$3.13. You'll note that the diluted share count is a different number than the basic share count we typically report. This change has to do with a slightly nuanced accounting treatment for companies with outstanding converts like Wayfair. As net income turns positive, accounting rules dictate that the diluted share count reflects the potential settlement of the converts via assuming a full equity settlement. To be clear, we still have the option of settling each of our three outstanding public convert maturities in either cash or stock or some combination. The accounting treatment does not indicate

that we have made any sort of settlement determination, nor does the diluted share count reflect the three capped call instruments we have in place. Together, an unwind of our capped calls at their respective cap prices would result in 6.7 million fewer shares being issued than what the diluted share count currently portrays. All of this is to say that while we're reporting diluted EPS in accordance with the appropriate accounting standards, we view the fully-diluted share count that you see in our reported financials as overstated. It will be lower, based on anticipated cap call proceeds, as well as any final decisions we make with respect to the form of convert settlements over time. If for example, we settle all the public converts in cash, none of the dilution related to these instruments will take place. Consistent with how we've always operated, we remain extremely sensitive to dilution and are keeping all options open and you should expect that we will be very thoughtful about managing our capital structure to mitigate dilution.

Free cash flow for the quarter was \$1.1 billion and we ended the quarter with approximately \$2.4 billion in cash, cash equivalents, and short-term investments. Clearly, we have come a long way in a short amount of time and have significantly reinforced the balance sheet, both due to our internal actions and external financing decisions. This financial flexibility puts us in a very strong position.

Now, turning to guidance. I wish I could say to you that we're back to normal and that we are ready to give you relatively accurate ranges for what might play out in Q3, but unfortunately, we recognize that there are too many unknowns in this environment, particularly in the US, which is by far our largest market. We faced a vibrant demand backdrop in Q2 and we have reason to believe that customers will remain focused on their homes in the back half of the year. While the unemployment picture is still quite tenuous, the competitive landscape is highly dynamic, consumers are justifiably nervous, and some government support is expiring. In our business, the mass market customer has to show up every day.

Though our business model will serve us well relative to other retailers in a recessionary environment, there is just too much uncertainty right now to try to predict revenue in a highly specific way. Instead, I will take the same approaches I did back in May by offering a look at our interquarter gross revenue trends, but will not go so far as to provide guidance for the third quarter as a whole. I'll also share with you what we would expect the rest of the Q3 P&L to look like if net revenue growth were closer to 20% year-over-year, while acknowledging that the actual profit results could vary from this view just as they did in Q2. I will add, however, that the magnitude of efficiencies and associated margin leverage we experienced in Q2 is unlikely to fully repeat in Q3 to the extent that revenue growth moderates sequentially as it has thus far in the quarter.

Quarter to date, our gross revenue growth is trending at approximately 70% year-over-year. While these run rates are still very robust, we are seeing more day-to-day and week-to-week volatility thus far in Q3, compared to what we observed in Q2, and expect that the volatility and the revenue growth rate deceleration may continue through the quarter. We are only offering these insights in the spirit of transparency as you build your models, but we do not have enough data points to call a sustainable trend and give specific revenue guidance, particularly as the state of reopenings around North America and in Europe evolves in real time.

Recognizing that it's challenging to predict the margin benefits related to potentially outsized volume growth and unique market conditions due to COVID, we want to continue to orient you to the more structural margin improvement we are capturing as part of our internal strategic plans. On that note, assuming a scenario with only a 20% rate of net revenue growth in Q3, we would expect gross margins in a 26% to 27% range, customer service and merchant fees closer to 4% of net revenue, advertising as a percent of net revenue between 10% and 11%, and SOTG&A to once again be modestly below \$400 million, including depreciation and amortization, but excluding stock-based compensation. All of this is to say that Q3 should prove our second consecutive quarter of positive adjusted EBITDA at a total company level, even without COVID-related tailwinds.

To help you with a few more housekeeping items, please assume equity-based compensation and related tax expenses of approximately \$78 million to \$80 million and depreciation and amortization of approximately \$70 million to \$75 million. We expect basic weighted average shares outstanding to equal approximately 96 million, though our diluted weighted average shares outstanding will ultimately be driven by the net income result in Q3 and impacted by the accounting rule I noted above. Finally, we expect CapEx in a \$95 million to \$105 million range in Q3.

We have long discussed with you the when and how and how much of a profitability inflection for Wayfair. Some of these questions were addressed in Q2 and we expect to further speak to the sustainability of this turning point with another set of profitable results in Q3. Though the elevated demand in the last several months somewhat obfuscates the underlying improvement in our economics, it also helps to reveal more about the long-term profitability potential of Wayfair as we build on our position as the most trusted, robust, and top-of-mind platform for customers and suppliers in the home goods ecosystem.

In the here-and-now, however, visibility is strained and there are multiple conflicting vectors to consider. The e-commerce shift remains real and powerful and consumers are finding high satisfaction as they adopt e-commerce and Wayfair. They also have good reason to remain focused on their homes. Yet recession risk still looms real, the competitive landscape remains fluid, and the state of reopening is ever evolving. Regardless of the macro environment that comes our way, we are focused on executing with strength every day and on further reinforcing Wayfair's highly differentiated model, for the long-term. And we have the operational and financial strength to definitively do so.

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.

Thanks, Michael. 2020 has thus far been a remarkable and challenging period for all of us. [ph] Even I'm (40:59) proud and impressed with how everyone at Wayfair has stepped up to support each other, our customers, our suppliers, and our local communities. There's no telling quite what plays out over the coming months but regardless, we are committed to being the go-to solution for our customers as they seek comfort in their homes and a strategic partner to our suppliers as we navigate these uncharted waters together.

Now, Steve, Michael, and I would be happy to take your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Again, we ask that you keep your questions to one question and one follow-up to allow everybody a chance to ask their question. Your first question comes from Peter Keith from Piper Sandler. Your line is open. Peter Keith, your line is open.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

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Sorry about that everyone. Thanks for taking the question and congrats on the results. The swing to profitability is quite impressive and dramatic. So, I guess on that note, I wanted to just ask you about the long-term EBITDA margin target of 8% to 10%. I think we've gone for years wondering when you might get there. And now, asking are you rethinking that that could be higher? And perhaps specifically around the gross margin, which was probably not sustainable with what you saw in Q2, but was guided very solidly for Q3. And you'd mentioned increased supplier listings, leverage of CastleGate, et cetera. So, how are we thinking about the longer-term margin structure given everything you've seen the last couple of months?

Niraj S. Shah

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

A

Hi Peter. Thanks for your question. This is Niraj. So, let me try to answer the question by giving you some color on a couple things. So first, just to recap a bit of history that I know you're aware. For years, as we've described, the gross margin runway and what we've been investing in, even while gross margin was steadily between the 23% and 24% range that we were continuing to guide, we had described that the bridge between that and the long-term gross margin, which was a few hundred basis points higher in the model that we had four different levers, that each alone could eclipse that whole gap. And so the first one was suppliers gaining efficiency and leaning in on our platform. The second was gains associated with logistics. The third was all the merchandising improvements we were making and the gains associated with those which is house brands, red carpet merchandising, and the like. And the fourth was seller services with sponsored products being one example of that [indiscernible] (43:56) the CastleGate business versus some merchandising services, et cetera.

And when we described that and we talked about that, that large 1,000 basis points plus runway, we basically said that, well, it's going to take a long time to unlock all of it, it would be over multiple years, but that we're making good headway. We're now at a point where some of these gains are starting to come through. And what's happened is it's then been accentuated by the surge in volume associated with COVID providing efficiencies that, to your point, will lapse. But if you just look back over the last few quarters, you can see how gross margin sort of broke out of the 23% to 24% range, got to 25%. How Michael then guided it to be 26%. Now how he's guiding it to be 26% to 27% even while revenue would be at the 20% growth rate. So, in other words, there's structural gains coming through. And there's a long runway still on those. So, if you think out multiple years, the long-term model, frankly, is something that we will update for you and give you some color on it. And a much better understanding of the gross margin trajectory, and we'll do that at some point here down the road. But I think, even with certain pillars, like Seller Services, frankly, weren't even contemplated when we built that model. So, there's a long runway. Now, specifically in this quarter, on one hand, we have structural gains starting to come through. On the other hand, there's some COVID surge-related gains of efficiency that will dissipate. So gross margin's going to continue to advance but there is that put and take.

But the point being though, the long-term EBITDA potential in the business is incredibly high. And what you can see in this quarter with it shining through, is you can actually see that it's been there. We've pointed to how that

embedded profitability is very high, but that we are also investing aggressively in the long term. And so, even in today's P&L, even with the \$440 million in EBITDA in the quarter, and the billion dollars of free cash flow, we still literally have thousands of people working on things for the future. And we're still investing at the maximum rate that we can do productively. So, that's really what the plan that we put in place at the end of last year was about. It was about making sure that the priorities could be executed very well and that we weren't trying to do too many things in parallel which would erode our ability to execute on our top-tier priorities. But those top-tier priorities were not near-term in nature. They're long-term in nature. And the two big expensive ones, which are really Europe and our logistics network, we are pretty far into them. And so, what's nice is we can be investing a tremendous amount of money against a tremendous amount of capabilities and still in the P&L and you can see how we're still very profitable with that still is true, and that will continue to play out over time.

Operator: Your next question will come from Maria Ripps from Canaccord. Your line is open.

Maria Ripps

Analyst, Canaccord Genuity LLC

Q

Good morning, and thank you for taking my questions. So, in the markets that are reopening, can you maybe give us a little bit more color on what you're seeing in terms of trends relative to average quarter-to-date trends that you highlighted? And then secondly, on international, can you update us on where you are in your international markets in terms of key customer KPIs and marketing efficiency? And do you have eyes on any additional international markets at this point?

Niraj S. Shah

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

A

Thanks, Maria. On reopening trends, what we've noticed is the economies that have reopened or reopened earlier that growth does dissipate there a little faster but it still stays at very elevated levels relative to where we were before. And so, I think you can think at this point, quite a few markets that we're in are reopened to some decent degree and you can – Michael said that revenue quarter-to-date was about 70% range. So, you can keep in mind like it's – that is with stores open. Although obviously, you have people perhaps not wanting to go to stores, so you say that is a COVID-related tailwind. But then, frankly, we picked up a year's worth of new customers in just one quarter. And so, those customers, we're seeing great repeat behavior from them and ongoing engagement. So, I think, frankly, even as reopenings continue, we're going to see that the secular shift to e-commerce has been accelerated meaningfully and then that continues and that rolls forward.

In terms of your second question around the international business, we are seeing – so the international business [ph] just to remind us (48:25) three countries are in that, Canada and then two countries in Europe, the UK, and then Germany. And they're all continuing to develop very, very well. Now, international will continue to be an investment area for quite some time. But as it gets bigger, it will get the same efficiencies that we have in the United States. And each country is moving along that trajectory at the rate we would expect. So, it's actually coming along quite nicely. In terms of other geographies or countries to enter, we have no immediate plans on that. But I think the way to think about that, over time, is that in Europe, we've invested in building an infrastructure that would support us throughout Europe. So, in other words, today, even though we only deliver into the UK and Germany, we actually have suppliers all across Europe, in Poland, in Spain, in Italy in the Netherlands and Denmark. So our transportation logistics network allows all of those goods to flow all throughout the continent and the UK as well. And, so, there's obviously opportunities to deliver into other countries, and pick up that benefit, similar to when we actually optimized the Canadian business and we saw it grow very nicely and very quickly because of all the US investments. And so, we'll get to that. But right now, the focus is on these same four countries.

Maria Ripps

Analyst, Canaccord Genuity LLC

Got it. Thanks so much for the color.

Q

Operator: And your next question comes from Heath Terry from Goldman Sachs. Your line is open.

Heath P. Terry

Analyst, Goldman Sachs & Co. LLC

Great, thanks. Niraj, when you look at sort of where you are from a capacity utilization standpoint and the level of investment that you're making into your infrastructure, obviously, this was a year where you felt like you had built some excess capacity into the system before we got into the environment that we're in. Given the short timeline between here and what's likely to be a lot of demand that you're going to see during the holiday season, how well prepared do you think you and your third-party suppliers will be to deal with that demand?

And when you look at sort of the longer term trajectory of what you're going to need from a fulfillment perspective, from a CapEx investment perspective, how long should we anticipate sort of this level, or potentially even higher levels of CapEx investment into the business? Obviously, with the understanding that it's all going to be sort of very productive, very good return on that investment.

Niraj S. Shah

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

Thanks Heath. Yeah. So to your question, the network we had built, the 60 million square feet, it really was – it had a tremendous amount of capacity that we were not yet utilizing, because the focus during that first phase was to make sure that we had the footprint, the geographic footprint we needed. And with the racking projects and some of the automation projects that we've been doing, we're basically accreting more capacity without taking on more square footage.

And so, we have quite a lot of capacity left in the network. And a lot of the projects that are continuing that are underway. And we've not slowed the plans due to COVID, but frankly, we haven't really accelerated. We're on the same plan, and it's going quite well. And so, I think the CapEx guides, Michael can maybe chime in, I think it's been [ph] around \$100 million (51:55) a quarter, plus or minus. And that plan basically allows us to continue to develop the network.

And also keep in mind, when we planned the network, we planned a couple of years ahead, because basically, these buildings don't necessarily exist until [ph] last thing (52:21) you're having them built to your specific needs, et cetera. And so, we're continuing to develop the network. But I think we're in very good position to serve the demand, despite the elevated level, because of the investments of the past few years.

And then one thing I would highlight, when you mentioned our suppliers, as well. They obviously, over the years, have been working on optimizing their business for e-commerce more. So, that basically means making sure that their network is more integrated with our network; their network has more capability. And frankly, more specifically, it's really around inventory availability.

And so, as we've ramped up our demand forecasting capabilities, we've been able to give them more guidance on what we would expect, based on what we're seeing. And then as we integrate the logistics network and as we can handle, for example, how we're flowing ocean freight into port-based locations so that the last mile is much

A

shorter, faster, less expensive, and the delivery promise can be very fast delivery promise. That creates a lot of benefit for everybody.

And so, then in this period where you see demand take off in the spring, and obviously that means you're going to run through inventory more quickly, we can very quickly start forecasting, and with them, we can then start planning ahead. And this is what we're starting to see, is that while there's periods where inventory levels were a lot lower than we would like, one of the things Steve referenced earlier in our prepared remarks is that we're actually seeing inventory building back up nicely right now because of how quickly we were able to respond to it earlier. And so, then when we look forward to the rest of the year, things like Way Day and holiday, we're pretty excited about the inventory levels we'll have.

Heath P. Terry

Analyst, Goldman Sachs & Co. LLC

Q

Great. And that level of comfort extends to your last mile delivery partners, they're going to have the capacity this holiday season to be able to accommodate the surge that you're going to need them to?

Niraj S. Shah

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

A

Exactly. So, I think the way to think about that is when the COVID-related surge first took off; no one was prepared for it. So obviously, everyone starts scrambling. Then as the weeks and months go by, you see the delivery capacity keep increasing, you see the delivery speed get better, you see, et cetera, et cetera. And so, what you can expect is as we continue to move through time, is that actually we should see all of those things improve versus worry that the kind of forward-coming demand would be a problem.

Heath P. Terry

Analyst, Goldman Sachs & Co. LLC

Q

Great. Thanks, [ph] Niraj (54:41).

Operator: Your next question comes from Jonathan Matuszewski from Jefferies. Your line is open.

Jonathan Matuszewski

Analyst, Jefferies LLC

Q

Hey, guys. Thanks for taking my questions. Nice quarter. First one was just on your conversations with vendors during the quarter and kind of what those conversations revealed regarding potentially higher propensity to use CastleGate going forward, and kind of whether you expect accelerated adoption rates versus history as suppliers kind of realize this new dynamic, and kind of rising consumer expectations. That's my first question.

Niraj S. Shah

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

A

Yeah. Let me say a little bit and then Michael can maybe chime in, if he wants. What I'd say is what we're seeing is that – what we're seeing is suppliers are clearly – so, let me start from a super-high level. Suppliers were already excited about e-commerce. The series of events that have transpired this year have only made them much more interested and excited about e-commerce. What we see from our suppliers is they view Wayfair as their natural primary platform for home.

And so, a lot of what's transpired over the quarter, so the surge in new customers, and then what we've then seen is that these are actually very high-quality new customers. The repeat behavior on them is very high. We've then shared a lot of that information with our suppliers and then that turns into a demand forecast. Then they see the demand is building in a steady, predictable, long-term way. Then our suppliers are integrating some of our long-term plans. The fact that we have thousands of people who are working on initiatives for the future, a lot of those will stimulate demand.

And so, this all ties together. Specifically on CastleGate, we continue to see an increase in adoption. We've added more suppliers into the program; we're adding more capabilities into the program. So, I think what you're going to see from suppliers is that we're effectively going to have a more integrated logistics network, and that will be the combination of three things. We'll see more suppliers using CastleGate; we'll see suppliers increasingly improving the quality of their logistics operation and having it more integrated with ours.

And then you'll see that the demand forecast that the item level will create integrated solutions at the item level, whether that be Asian consolidation or direct containers into CastleGate at port locations or using their logistics network in parts of the country where they actually have capabilities versus where they don't, et cetera, et cetera. And that combinations – more and more suppliers are kind of working with us on this bespoke-type opportunity, which basically creates more and more benefit and it does result in them using more and more of our CastleGate and logistics services. Michael, is there anything you wanted to add on this?

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

A

No. I think the only thing I'd add is, I think we mentioned that we've nearly doubled the wholesale dollars running through CastleGate this past quarter. And just echoing what Niraj was saying in all of our conversations with suppliers, and as Steve mentioned, we're all spending a lot of time talking to our supplier partners. It's very clear that they've used this opportunity in this moment to lean in with Wayfair.

And I think they're reassessing the sort of entire retail landscape and they see the movement from offline to online in a more powerful way than they ever did before. I think this is a little bit of a shock to the system for many of them. And so, I think tipping all those folks sort of more and more to our business model is clearly an outcome we're going to continue to see on the forward quarters coming out of this COVID period.

Jonathan Matuszewski

Analyst, Jefferies LLC

Q

Great. That's super helpful. And then just a quick follow-up. You mentioned Way Day. Sounds like it's still in the works for 2020. Can you share any thoughts in terms of timing for the event and how you may be thinking about it differently this year versus last?

Niraj S. Shah

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

A

Yeah, sure. So, Way Day obviously is a very big event for us. This will be the third year having it, and obviously, it's traditional spring timing we moved because of the – obviously, the events of this year. So, the current plan is to have it linked this quarter. And so, similar to how Michael explained that, last quarter where the order intake was over 90%, and it actually continued to be over 90% through the end of the quarter, but you see the net revenue came in at 84%. That was some revenue moving into this quarter.

Well, the timing of Way Day later this quarter, you're going – I think Way Day is going to be quite successful, but the actual revenue, because on delivery day, a lot of that will show up really next quarter. But we think it's a good timing of being able to have it sort of separated enough from holiday, but actually have the opportunity to [ph] tabulate it (59:01). So, that's our current plan for Way Day and we're excited about it.

Jonathan Matuszewski

Analyst, Jefferies LLC

Makes sense. Best of luck, guys.

Niraj S. Shah

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

Thank you.

Operator: Your next question comes from Justin Post from Bank of America. Your line is open.

Justin Post

Analyst, Bank of America Merrill Lynch

Great. Thank you. A couple of questions. Just first on the July update. Have – did the absence of Prime Day have any impact? And are you seeing any changes in the competitive intensity from offline retailers moving online or maybe Amazon in the home goods category?

And then second, bigger picture, maybe for Niraj, you've had a big increase in category penetration. Maybe if you have any thoughts on where that is now and where it was pre-COVID. And when you get into next year, and you kind of lap this big surge, do you think that penetration can keep growing next year? How are you thinking about that? Thank you.

Niraj S. Shah

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

Thanks, Justin. Let me try to answer some of those and then I'll let Michael add any color that he wants to add. In terms of Prime Day, I mean Prime Day does drive the kind of an e-commerce halo. But what I would say about this year is the comps have – there's weird shapes that have occurred relative to last year. So, like mid-April there was the stimulus. Usually in April, we have Way Day and we didn't. We're going to have Way Day later this year. Prime Day I would say is pretty modest in comparison to those other puts and takes. But even our events that we have are different timings than last year. So, if you're looking to zoom into like days and weeks, you do see some lumpiness. But fundamentally, I would say not that much impact from Prime day.

Competition, so, I think Amazon, Walmart, reduced some of their online advertising for a little while and then came back in. In truth, if you look at the impact of that, it's actually quite small because it's primarily in one of the Google advertising products, the PLAs, where we are actually the outsized player in our categories. And so, while folks move in and out, it affects you a little bit. There's actually quite a few other players of the same magnitude as them and that's Home Depot and Lowe's and a series of others – Target. And so, it's actually not as big an impact as you think. And so the way to think about it, to your point, we added \$2 billion in revenue this quarter year-over-year, and we did it while driving the sustainable profitability which is a continued thing that we're going to do.

So, I think what we're going to see going forward, is we're going to have significant growth while having the profitability shining through. And that's because of the combination of our size and the nature of that, even in the P&L today, you see the investments and we're getting gains from some of the investments that we've been

focused on over the last couple years. So, that combo is going to continue to drive things forward. So, you're going to see this develop, I think, incredibly nicely.

In terms of the tactical question on lapping this period next year, I guess, the way we think about it is, we focus on the outcome and that's measured in years and many years. And, so, we don't really worry about exactly what happened in a given period of weeks or in a quarter. But I expect we're going to be able to continue to grow. And I would expect that primarily because, even at the size we're at, we have a very small share of the total category.

To your point about online category penetration, I do think it jumped up. But I think a lot of that will prove to be sticky. And, I think, frankly, the large number of customers we got; I think a lot of them will prove to be sticky. And we're seeing the early results of that. So as a result, I think we're going to be able to keep growing, and I think we're going to be able to keep taking share in the broad-based home category. And to your point, this year might be a bigger step up in penetration than you see perhaps next year. But I think if you kind of like zoom back out, you're just seeing a one way road where penetration's growing. Michael?

Justin Post

Analyst, Bank of America Merrill Lynch

Great. Thank you.

Q

Niraj S. Shah

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

Do you have anything you want to add there?

A

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

No. I think you covered it really well, Niraj. I think this notion that if you think about how many new customers we just picked up and the positive experience they have with Wayfair and, as we know, our business is predicated on repeat. And so when you start to think about not just the back half of this year but next year in that long-term perspective that we tend to have, we're thinking about those customers, how to super satisfy them and make sure they keep repeating. And that's sort of a bolus of new penetration that should continue to serve us well, not only in the back half of this year but into next year as well.

A

Justin Post

Analyst, Bank of America Merrill Lynch

Great. Thank you.

Q

Niraj S. Shah

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

Thanks, everybody. I think that wraps up the call. So, we appreciate your time. And hope you're all healthy and safe.

Operator: Thank you everyone. This will conclude today's conference call. You may now disconnect.

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