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Wayfair, Inc. (W)

Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and thank you for standing by. And welcome to the Wayfair Q2 2021 Earnings Release Call. At this time, all 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 hand the conference over to your speaker today, Ms. Jane Gelfand, Head of Investor Relations, Capital Markets and Corporate Development.

Jane Gelfand

Head-Investor Relations, Corporate Development & Capital Markets, Wayfair, Inc.

Good morning, and thank you for joining us. Today, we will review our second quarter 2021 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 Margaret Lawrence, Vice President of Wayfair Professional and Perigold. 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 2021. 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 2020, 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 any of 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, including 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 and investor presentation, which contains descriptions of our non-GAAP financial measures and reconciliations of our 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 and Co-Founder, Wayfair, Inc.

Thanks, Jane, and good morning, everyone. It's great to reconnect with you all today to cover the details of our second quarter results and to share some of our observations during this dynamic period.

Let me start off by saying that Q2 came in slightly differently than we initially expected. A bit more subdued on net revenue and stronger than we had forecasted on profitability and free cash flow. Many of you have had questions as to whether Wayfair can be sustainably profitable as the pandemic recedes. And this is clear evidence to make that case. This quarter represented the toughest year-ago comp as we lapped the surge of pandemic-driven demand in the spring of last year. Against that backdrop, vaccination rates picked up, the economy more fully re-opened, and consumer behavior understandably adjusted.

At \$3.9 billion, Q2 net revenue was down about 10% year-over-year, but grew 11% relative to Q1 and the two-year CAGR was north of 28%. As we discussed when we last spoke in May, sequential growth rates and two-year growth metrics will likely be more telling for investors until we get past 2021. Despite any short-term noise, the underlying structural elements for continued long-term category demand and share transfer to e-commerce remain in place. Consumer balance sheets are strong and interest in the home is not going away post-pandemic, even if there is some shorter-term normalization.

As an example, our annual Way Day event in Q2 proved to be the largest in the company's history, even as consumer spending began to flow back to experiential categories. Our customers, in particular, tend to shop one item, one room, one project at a time. And while they're may be rebalancing their spend some, home-to-do lists are nearly endless, supporting the large size of the category.

Wayfair should grow even faster as category demand shifts structurally online. At roughly 20% penetrated in our most developed geography and set of classes, there's a long runway ahead for online share of the home category to grow. While there may be some short-term rebalancing towards brick-and-mortar over the next couple of quarters, we are convinced the structural trends towards e-commerce will hold and potentially accelerate.

History tells us that e-commerce gains tend to speed up when categories cross the 20% threshold and the pandemic helped bring us to this point. Wayfair is furthering that e-commerce shift and our own wallet share capture by building out an unparalleled offering in more than 1,000 classes of home across four key verticals: Furniture and Decor, Housewares, Home Improvement and Professional. We'll speak in more detail about our

Professional business today, but it's worth noting that while Furniture and Decor is our strongest and largest vertical, we already enjoy good scale across each of them.

We're also building our business across both North America and Europe, two immense markets, which combined, are more than \$800 billion in size. These dynamics may be hard to see by focusing on Q2 alone, given the challenging year-ago comparison. On the surface, what you'd see is a modest decline in active customer count and slightly lower order frequency. But zooming out, you would recognize that we acquired nearly 18 million new customers over the course of 2020, with about one-third of those in Q2 last year.

In Q2 2020, we also saw more frequent purchasing with smaller basket sizes as customers outfitted their homes for the demands of sheltering in place, remote working, and schooling. While not all of our recently-acquired customers will be in the active count at all times, they are now part of our customer file and are highly engaged. We now have one-on-one relationships with these customers, which allows us to develop individual insights about them as they engage with Wayfair, which happens much more frequently than they purchase.

We then use these insights to personalize our content and communication with them in low-cost ways. Meanwhile, we're seeing repeat trends evolve as we would expect. That is except in Q2 of last year at the height of the pandemic, repeat orders typically outpaced new orders, and this is continuing. As a result, repeat as a percent of total orders reached new highs at more than 75% this period. We are focused on driving repeat orders in a few ways: by converting new customers into repeating customers through building frequency with our shoppers and by reengaging past customers who may have lapsed. The pandemic provided a strong push on each of these fronts. We believe we are leaving the pandemic period with an even stronger repeat customer base than when we entered it, which should have long-lasting benefits, given it cost us relatively less to drive repeat purchases than initial orders.

As we go through this normalization period, we are very mindful of balancing the needs of our customers and our suppliers and believe the Wayfair platform is advantaged in doing so. One advantage is our access to selection and inventory. That said, you are well aware that industry stock levels have been depressed for some time and exacerbated by bottlenecks at nearly every point in the supply chain.

We are seeing sequential improvements in inventory availability and fulfillment, but the progress is incremental and does not happen overnight. Some port congestion is easing and our Asia-based international supply chain services are growing quickly to support our suppliers. We're also leaning into CastleGate as a solution with inventory availability improving. Yet the industry still has to deal with narrower selection and longer-than-desired lead and delivery times, which are unlikely to normalize until some point in 2022.

Our inventory-light model helps us foster substitution with more than 22 million products on the platform. And we're leveraging our logistics and technology solutions to closely manage customer delivery expectations, both pre and post-order. We believe this transparency is helpful in building long-term customer trust in Wayfair.

These long-lasting supply chain issues have also resulted in inflation. We're working with our suppliers to pass through some of these higher costs, while paying close attention to our customers' reactions to higher prices across all of our classes. So far, we believe customers are generally absorbing the higher prices reasonably well, though the operating environment is admittedly very fluid.

Where we have a view of cost pressures being more transient, we're being thoughtful as to how to reflect that to the end customer. This longer-term orientation has always served us well. And we have been rewarded by our customers and our suppliers.

Over the last 18 months, we have unlocked a lot of efficiencies that give us the ability to be very deliberate during this dynamic transition towards a new normal. With a seeming battle between variants and vaccinations, it is not totally clear how quickly we will reach a new equilibrium in each of our geographies. It's impossible to predict all short-term outcomes, so instead we come back to the fact that even with LTM net revenue close to \$15 billion, we are still less than 2% of our \$840 billion addressable market.

We remain most focused on the various elements that make Wayfair's platform a structural category winner, with both customers and suppliers alike, things like best-in-class selection and merchandising and purpose-built technology and logistics solutions.

We believe we can do all of these things, while outpacing category growth rates and remaining solidly profitable throughout. With a strong balance sheet as a foundation, you are also increasingly seeing our confidence reflected in our capital allocation decisions, as we stepped up our buybacks in Q2 and repurchased \$300 million worth of shares.

One of the areas where our long-term mindset is really paying off is Wayfair Professional, our B2B business. We're coming back to the tradition of introducing you to our leadership team, and Margaret Lawrence is here with us today to discuss B2B. I'll now turn it over to her.

Margaret Howell Lawrence

Vice President, Wayfair Professional and Perigold, Wayfair, Inc.

Thanks, Niraj, and hello, everyone. I'm glad to be joining you today to discuss Wayfair Professional, our dedicated business brand, which I hear many of you have been eager to explore more. I joined Wayfair over four years ago and have led Wayfair Professional since the beginning of my time here. Over the last six months, I've also assumed responsibility for our Perigold brand. We'll leave the Perigold discussion for another time, but it has some clear similarities and synergies with B2B, and I'm very excited about its potential.

Prior to Wayfair, I held leadership roles at Google and in the venture capital world. Our vision for Wayfair Professional is to be the destination for all things furniture, fixtures and equipment for every business. There are more than 45 million businesses in North America and 30 million businesses in Europe. Our focus is to serve each of these in a differentiated way, particularly when it comes to those design-driven purchasing decisions, where our professional customers benefit from the same core elements that make our overall business special, selection, service, value and speed.

Wayfair Professional first evolved as many business customers initially came to the Wayfair platform through our consumer-facing site. We recognize that these customers were very different in nature and that there was an opportunity to build a customized experience for them. We started the early work in 2015 and officially launched the Wayfair Professional brand in the US in 2017. Since then, we've grown meaningfully with the number of active customers growing at a more than 30% CAGR.

In addition to our vast B2C catalog, the number of commercial-grade products on site has grown by approximately 25 times from when we started. And nearly all enquiries are now handled by dedicated B2B service reps. As we speak, we are beginning to formally expand our B2B reach into Europe. There, we have already informally achieved some nice early scale by serving professional customers through the B2C platform, much like our initial trajectory in the US.

Wayfair Professional is experiencing great momentum in the market, now with north of \$1.5 billion in annual net revenue. We enjoy strong and strategic customer relationships with businesses of all sizes from sole proprietorships to Fortune 100 companies, of which 84 are active customers today.

More importantly, there is an enormous future opportunity here with the total addressable B2B market approaching \$200 billion across North America and Europe, of which we estimate less than 15% is spent online. While we serve businesses across many industries, we're currently most focused on seven verticals: interior design, commercial office, contractors, property management, accommodations, education and foodservice.

To date, the main thrust of our efforts has been on the first three, which cover more than half of the TAM, but we also already have meaningful offerings across the remaining verticals and are actively expanding our coverage there. Some verticals, like interior design, skewed towards core Wayfair assortment, while others like commercial office need distinct suppliers, products and merchandising.

Each industry has its own competitive set, and we win when we get the recipe right for each vertical. There are some core capabilities that we can leverage throughout, like sophisticated order management solutions and proprietary logistics. But across each vertical, we layer in a differentiated set of tools to meet the unique needs of those businesses.

For instance, contractors can arrange to have every item from a large project or multiple orders arrive on site at one-time, while interior designers can have access to a vast array of product options across our universe of brands, all with fast delivery, powered by our logistics capabilities. We can meet the specific needs of these customers, thanks to our more than 16,000 suppliers, nearly 18 million square feet of fulfillment space via CastleGate, and our own middle-mile and last-mile network in WDM.

Though each set of B2B customers is unique, it should perhaps come as no surprise to you that professional customers, as a whole, have a very different profile than our B2C shoppers. For instance, the average professional shopper visits more frequently, buys more often and spend more each time they purchase than our B2C customers each year.

Over the last 12 months, 80% of Wayfair Professional orders were placed by business customers who have already placed four or more lifetime orders. We have designed a unique funnel for our B2B shoppers that showcases the best ways that Wayfair can help them. It begins with customer acquisition where we operate with the same data-driven payback minded marketing philosophy as the rest of the business, while optimizing for B2B reach through some unique business-oriented channels.

We are also tuned in to recognize when businesses come on to the platform through the B2C experience, at which point, we adjust our marketing strategy to move them into the Wayfair Professional ecosystem. An enrollment process, verification and a gated site allow us to show additional assortment exclusive to businesses, and provide the opportunity for our suppliers to lean in with sharper business pricing.

Customer service looks a bit different on the B2B side of the organization. In the traditional off-line universe, customers may have to work with a dozen or more different providers to complete a single project. We focus on demonstrating how they can use our tools and services to complete their entire job through Wayfair Professional. We have many self-service options that are custom-built for various use cases, with tools such as quote creation and management, project organization, buy it again for easy repeat purchases, and bulk cart edit functionality to manage larger baskets.

For professional shoppers looking for a higher touch level of support, our more than 500 business account managers help to educate customers about Wayfair services and proactively reach out to intercept emerging needs as we help them complete their orders and projects.

Our team has a wide array of capabilities, including design services, custom sourcing, coordination of support for multifaceted orders and consolidated delivery, all of which we offer as additional options to create a seamless shopping journey for our B2B customers. Our customer engagement doesn't end after our customers made the purchase. Specialized customer service representatives, dedicated to B2B, handle the vast majority of calls from Wayfair Professional customers, leading to lower average handle time despite additional complexity, as well as the higher NPS.

During the pandemic, Wayfair Professional seized the opportunity for differentiation versus the competition and accelerated our forward momentum. There were moments of uncertainty and some natural volatility along the way, but we leaned into these as a chance to more closely partner with our customers at a vulnerable time. We expect that these will translate into tighter relationships and higher customer lifetime values well beyond the pandemic. Let me share a couple of examples.

Last year, our team worked with a logistics company that came to us looking to quickly open three new office locations on the back of supercharged business momentum. We leveraged the full range of our commercial office capabilities, including space planning, design, custom sourcing, and custom logistics. We were able to complete the project within their existing budget and on an ambitious eight-week timeline, thanks to our strong supplier relationships and top-tier fulfillment expertise.

Our ability to execute quickly was a huge win for the customer, especially given the complexities introduced by the pandemic and has since led to several more projects we worked on together.

Over the last 12 months, we worked with more than 35,000 customers in the foodservice space as they've reoriented their businesses around evolving norms. One great example, earlier this year and in anticipation of a busy spring season, a restaurant customer decided to convert an unused outdoor space into a stylish patio over a very short timeframe.

Our design team quickly got to work, conceptualizing what this customer could do with the space and worked in tandem with our product sourcing and consolidated delivery teams to find, order, and install the necessary products, all in less than 30 days. The restaurant owners were thrilled with the outcome and are in ongoing discussions with us to support future expansion.

Now that macro conditions are normalizing across the US, many of our business customers are in the midst of a meaningful refresh cycle. Hotels, restaurants, and schools are all reopening and adapting to new norms, while contractors and interior designers are busier than ever.

We are focused on making Wayfair Professional their one-stop solution and have a long roadmap of new initiatives ahead, such as offering even more project financing options to help many of our small business customers get started.

I'll wrap up by saying that I'm so proud of the team we have built. Our Wayfair Professional colleagues are enormously talented and motivated. The Wayfair brand and platform is a powerful, well-known calling card as we scale the business, and the resources we have at our disposal, are largely unmatched in a fragmented industry.

We have enviable momentum in North America with a long runway ahead and are just starting to embrace a proven playbook in Europe, which is another very large market. I would be remiss if I didn't mention that we are doing all of this with already solid bottom-line economics.

I'll now turn it over to Michael and look forward to keeping you apprised of progress over time.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

Thank you, Margaret, and good morning, everyone. Let's take a look at the financial details for the second quarter before discussing the forward outlook. As you saw in our press release this morning, Q2 total net revenue was \$3.9 billion. This was \$447 million less than the second quarter of last year, representing a 10.4% decline year-over-year. We are now comping what was a truly extraordinary period a year ago.

So, the moderate year-over-year decline is not a surprise. We are seeing a change in the macro environment as consumers embrace a reopening economy and are beginning to rebalance spend towards categories they have sorely missed over the past 18 months.

This makes complete sense, though we would not expect interest in the home category to meaningfully wane sequentially. So, rather than dwelling on year-over-year noise, we are instead focused on quarter-over-quarter trends. On this basis, Q2 net revenue dollars were 11% higher relative to Q1. Gross to net translation did normalize year-over-year, leading to percentage growth rates in net revenue terms that were above the gross revenue rates. The US net revenue declined 15.2% over Q2 of 2020, down by \$554 million year-over-year. Quarter-over-quarter, US net revenue grew by 9.8% compared to Q1.

Our international geographies are a bit behind the US in terms of reopening. So Q2 momentum was stronger in this segment. International net revenue grew by 16.3% year-over-year, or \$107 million, and was up by 15.6% compared to Q1 2021. On a constant currency basis, International net revenue grew 3.2% from the prior year.

Turning to Q2 KPIs at the consolidated level. The last 12 months active customers surpassed 31 million this quarter, nearly 20% higher year-over-year. While order frequency over the last 12 months was 1.96, up close to 4% year-over-year. Both these metrics showed sequential declines, which makes sense to us given Q2 2020 rolled out of the last 12-month period and represented a peak moment for new customer acquisition and purchase frequency given the sudden onset of the pandemic.

The slight quarter-over-quarter decline in LTM order frequency was more than offset by higher average order values, resulting in LTM net revenue per active customer up 9% year-over-year and up 4% quarter-over-quarter. Higher AOVs represent two factors this period: cost inflation being passed through and higher than typical mix towards the outdoor category, which tends to have higher priced items [ph] or step (25:48).

I'll now move further down the P&L. As I do, please note that I'll be referencing the remaining financials on a non-GAAP basis, which includes depreciation and amortization but excludes stock-based compensation, related taxes and other adjustments. Q2 gross margin was 29.3%. You will recall that in Q2 of last year, we saw outsized efficiencies as orders stepped up sharply and these conditions normalized over the quarters that followed.

We are also now seeing inflation in transportation costs. You'll note that this is our third straight quarter of roughly 29% gross margins, which we believe is a nice representation of the inherent unit profitability in our business and the forward upside we can unlock over time, through the many investments, which we've previously discussed.

Customer service and merchant fees were 3.6% of net revenue in the second quarter, in line with our outlook. Advertising as a percent of net revenue was 9.1%, or about 60 basis points lower than last year. Higher repeat mix helped drive some leverage, but this result was still somewhat lower than expected.

We've said many times that the advertising outcome in any one quarter will depend on the opportunities we see in market, and there is some natural variability period-to-period as a result. This quarter, that long-term ROI orientation translated to less scale in some channels.

Our selling, operations, technology and G&A, or OpEx expenses, totaled \$408 million. This was slightly above our forecasted range due to higher than anticipated technology costs, somewhat offset by a slower pace of hiring. We are focused on making the right hires in a competitive labor market and are making sure to keep the talent bar high as we do so, and we feel great about the new people we're adding to the Wayfair team.

For the second quarter, adjusted EBITDA was \$311 million, or 8.1% of net revenue. In the US, adjusted EBITDA was \$323 million, or 10.4% of net revenue, while the International segment booked slightly negative adjusted EBITDA at negative \$11.7 million, or negative 1.5% of net revenue.

Moving on to the balance sheet and cash flow. We spent \$300 million on opportunistic share repurchases in the quarter. Through this move, we are signaling both our confidence in Wayfair's trajectory and taking proactive steps to mitigate dilution that could ultimately result from the settlement of our outstanding converts.

Even after these discretionary buybacks, we ended the quarter with \$2.6 billion of cash and highly-liquid investments on our balance sheet. In Q2, net cash from operating activities was \$275 million and free cash flow generation was \$207 million after factoring in \$69 million of capital expenditures.

Turning now to our outlook. Let me preface all of these remarks by underscoring once more how dynamic this period is, particularly as it relates to the top-line. By now, you will have seen a flurry of reports attesting to e-commerce trends, having predictably softened on a year-over-year basis in a reopening environment.

While we can make some educated guesses, it's difficult to be definitive about how things will trend from here. We all only have a few weeks of data in various cross currents, like vaccines and variants to contend with. I expect much more will be clear by the time we next speak. But for now, I'll do my best to give you some framing, though explicitly without providing precise guidance.

The faster-than-expected reopening has pushed out our expectations for a return to so-called normal quarterly revenue flow. Quarter-to-date gross revenue is down in the high-teens on a year-over-year basis at this point in Q3. Though year-ago comps do not get much easier for the rest of the quarter, we're cautiously optimistic. But as the emerging from COVID summer experiences wind down and people return to more regular work and schooling routines, we will see sequential improvement in revenue trends.

It is early days, however, and as I have always said, the customer has to show up every day. Putting all of this together, we now believe Q3 net revenues will be somewhat below Q1 and Q2 levels and are confident that revenue dollars should accelerate sequentially into Q4.

As a side note, gross to net differences should become less of a factor going forward. So you should interpret gross revenue trends as largely representative of net revenue growth rates. When it comes to gross margins, we have consistently reminded you that we believe 27% to 28% is a more sustainable near-term range for us, even as we've over-delivered some quarters in the midst of COVID.

With order volumes now normalizing and some near-term inflation impact, we do expect that gross margins will come down sequentially relative to the last two quarters and that 27% to 28% is still the right range. That doesn't take away from our long-term expectations for gross margin expansion.

But these things are never a straight line, particularly when the period is as choppy as it is today. We forecast customer service and merchant fees at approximately 3.5% to 4%. And while advertising as a percent of net revenue will move around depending on the opportunities we see in the period, we continue to see 10% to 11% as an appropriate range to forecast.

SOTG&A or OpEx dollars, excluding stock-based compensation-related taxes, should be approximately \$440 million in Q3. Based only on the top line trends we've seen quarter-to-date, this would translate to a low-single-digit adjusted EBITDA margin in Q3.

Touching now on a few housekeeping items for Q3. Please assume equity-based compensation and related tax expense of approximately \$89 million to \$91 million, depreciation and amortization of approximately \$80 million to \$85 million, interest expense of approximately \$8 million to \$9 million.

Basic weighted average shares outstanding equal to approximately 104 million shares. Though as a reminder, our fully diluted weighted average shares outstanding will ultimately be driven by the net income results in Q3 and the result of applying the if-converted method to our converts.

Finally, a couple of notes on cash flow. First, we expect CapEx to land in a \$70 million to \$80 million range, again, subject to timing. Second, as you know, we typically benefit from a positive working capital float. However, we tend to see net working capital outflows in quarters where revenue is sequentially lower.

You've seen this at work in nearly every Q1 across normal seasonal years. Given the current revenue trends, we're fully prepared for a negative free cash flow result in Q3, but this will be modest in the context of our very strong balance sheet.

Before we turn to Q&A, we need to acknowledge that this is probably the murkiest moment in 2021. Frankly, it's the most complex macro environment to read that I've seen in my entire career. Every public company is having to base its comments on only a few weeks of data, all while the macro and public health picture is rapidly changing.

We believe we'll get to a better view of consumer behavior as people settle into their normal routines post summer. We will, of course, remain prudent as we navigate any near-term normalization. However, we also know that by keeping our eye on the long term, including the bigger market opportunity, investing in strong supplier relationships and custom solutions for the industry, much like what Margaret just described for B2B.

And by staying focused on the customer, we derive hugely positive and sustainable long-term outcomes. For us, this translates to the ability to generate solid top line growth and bottom line profitability, while simultaneously investing to build an ever wider competitive advantage for many years to come. This is what we have always oriented Wayfair towards as leaders, employees, and fellow shareholders and what we continue to do today.

Thank you very much. Now Niraj, Steve, Margaret and I will be happy to take your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from Peter Keith with Piper Sandler.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Hi. Thanks. Good morning, everyone. Interesting comments on Wayfair Professional, sounds like it's now about 10% of sales already. I was wondering if you could comment how that's trended up as a percent of sales. And then longer term, where do you think Wayfair Professional could go as a percent of sales within your mix over the next couple of years?

Niraj S. Shah

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

Thanks, Peter. Let me – yeah, let Margaret take a shot on the question.

Margaret Howell Lawrence

Vice President, Wayfair Professional and Perigold, Wayfair, Inc.

Peter, thanks so much for the question. We have very large ambitions at Wayfair Professional. The trend has increased over the four-plus years that I've been at Wayfair.

And frankly, we're doing everything we can to serve the professional customer with the high-touch experience, the broad selection, adding things like consolidated delivery and financing options in the future. So we're doing everything we can to increase as a share of Wayfair overall and feel like there's a huge, huge opportunity ahead given the size of the market and where we are now.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Okay. Thank you. And maybe pivoting over to advertising, so it might be a play out, it was pretty efficient in Q2 below your regular run rate. Maybe could you hit two topics? What are you seeing now with some of the privacy changes, is that impacting your ad cost? And then more recently with this slowdown, are you seeing any irrational competitive behavior within the advertising landscape?

Niraj S. Shah

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

Thanks, Peter. Yeah. Let me try to answer this. So, yes, as you noted, ad costs came in round about 9% of sales this quarter, which is a little lower than it had been. But just to remind you, how we target ad spend. We don't actually set a budget. We, in fact – our goal would be to spend as much as possible, but however we tightly manage it with the payback.

And the payback we're inflexible on. And because we can tightly measure that, we have a pretty strong advantage because we'll then use technology in terms of targeting. We'll use creative optimization. We'll build new channels. We'll do all these things to grow our access to customers while keeping that payback tight.

And so as you noted, there's a couple of things that have happened recently in the market. One is obviously the privacy considerations continue to get tightened. We actually have a significant advantage there, both because

we have our own proprietary ad technology and because we have such a large house file of customers that we already know. And we can reach them on e-mail. We can reach them with app notifications.

And what this lets us do is in a very low-cost way, have a one-to-one relationship with them, that isn't reliant on using one of the larger media providers and their targeting. And so when someone like Apple doesn't let, the apps cross-track that doesn't really hurt us in the way it hurts others. We're really counting on third-party ad vendors helping them with that.

In terms of your comment about irrational ad spending, I will say, we've seen inflation in the market as sort of the world has reopened significantly in the countries we're in. But to just remind you, we don't chase that. So any time we see inflation that we think is irrational, we just won't spend into it.

And what we always see is any kind of burst like that tends to come back to rational as folks realize that they're overspending or what have you. And then we are able to grow our spend through all the methods I described around targeting and creative optimization like. So we feel really good about our ability to grow our ad spend over time, but you'll see us keeping it very efficient in terms of not changing on paybacks.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Okay. Thank you. Very helpful. Keep up the good work.

Niraj S. Shah

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

Thanks, Peter.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

Thank you.

Operator: The next question comes from John Blackledge with Cowen.

John Blackledge

Analyst, Cowen & Co. LLC

Hi. Two questions. One, just curious on back-to-school impact, is that a tailwind or a headwind this year? And then the gross margins were a little bit better than we thought despite the slightly lower top-line. Could you just talk about the levers there? And as we round through the year, just kind of the levers for the gross margins? Thank you.

Niraj S. Shah

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

Thanks, John. Back-to-school, I would say, should be a tailwind. But I guess I would take a step back and say, our business has like all these different pieces of seasonality in it. For example, the holiday, over indexes and housewares and people gifting things to themselves, right after holidays in January, that's one of the best seasons for entertainment furniture, because a lot of folks get a TV during the holidays and then they want their living room set up for the Super Bowl. Then the sort of textiles tend to do well in the spring, you have things like the outdoor

season, which is a very big season for us that starts in the late winter and runs through the spring into the summer. Back-to-school, obviously, you just referred.

So there's sort of like this ongoing pattern of different seasonal events that caused certain categories to kind of grow at certain times relative to others. So – but I would think back-to-school should be a tailwind, and we're just entering back-to-school now. Schools are just opening now and that sort of runs through the next six to eight weeks.

In terms of your question on gross margin, one thing we tried to highlight first, I would say, multiple years now, is that there's four main pillars that contribute to the growth in gross margins and that there's a very long runway on gross margins. And back when we were running at the 24% or so gross margin, I talked about how there's over 1,000 basis points of runway between these pillars and how at the time when our guidance was 25% to 27%, that few hundred basis points that any one of the four pillars could cover off that entire range.

But in fact, there's four pillars. Now gross margin's higher. I think Michael guided this quarter at 27% to 28% sort of despite what we're seeing in the market with supply chain congestion and these things.

And that's still – there's a large, large runway ahead of us. So just to recap those four levers really quickly. One is suppliers, as they do more and more volume with us, they can maximize our profit dollars at lower costing and that's going to allow our effective margins to increase.

And the second is we've been building an end-to-end logistics network that at this point is not just the – it's 18 million square feet and it's not just the warehouse and not just the transportation, but it goes all the way back to ocean freight and drayage. And so it's an end-to-end logistics offering that lets us tackle the logistics spend, make it much more efficient, and there's a lot of savings to come out of that while facilitating much faster end customer delivery.

The third lever is everything we've been doing on merchandising. The red carpet merchandising, the house brands, what we do with 3D imaging. And as we improve the experience there at a lower and lower unit cost, that effectively gets us gains on demand response, which accrued to margin.

And the last pillar is supplier services. And the oldest one we have is CastleGate. But over the years, we've added Wayfair Advertising to the mix. We have a merchandising offering that's in its very early days. And so we've had these additional supplier services that effectively allow suppliers to spend money with us on services that they otherwise do themselves or spend elsewhere in a way that's more efficient for them, gets accounted for as [ph] contra cost that (42:34) drives up gross margin, and that's another plus, very much in its early days.

So long story short, these are the pillars that add to – what you're going to see is a sustained rise in gross margin over time. Now your question was over the next few quarters. I don't know if I would make it that micro. I think over the years, we're going to see a very large rise in gross margin, but I wouldn't focus on anything changing particularly in a quarter or two.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

A

Yes. And, John, it's Michael. The only thing I'd add is, I think, when you look at the last few quarters, we've delivered 29%. The reason we continue to guide 27% to 28%, particularly as we look at what the period we're in right now, when we think about, as Niraj just pointed out, supply chain constraints, inflation, et cetera. I think the

27% to 28% is the right place to be targeting sort of for the near term, not taking anything away from the long-term opportunity to drive increased gross margin and increased EBITDA over time.

And I think you saw that in the changes we made over the last couple of quarters to how we're talking about the long-term and what we think the long-term opportunities are. And I continue to point everybody, Niraj, just did back to that when you start to [ph] figure out (43:49) what the opportunity is over the next few years.

Operator: And your next question comes from Steve McManus with Exane BNP Paribas.

Stephen James McManus

Analyst, Exane BNP Paribas

Q

Hey, good morning, guys. Thanks for taking the question. So I just wanted to follow-up on B2B. You spoke a bit about international, but I was just wondering what you're thinking in terms of the timeline there for a full rollout in Europe? Any color there would be great.

Margaret Howell Lawrence

Vice President, Wayfair Professional and Perigold, Wayfair, Inc.

A

Steve, thanks for the question. The way that we are thinking about market expansion generally is probably following our – the recipe that we've built and the success we've seen in the US. So as we build a robust business on the B2C side, there is an advantage to us waiting for that to happen and then layering on our Wayfair Professional platform, leveraging the customers that are shopping on the B2C sites, bringing them into our Wayfair Professional experience and then having a gated site experience focused on the verticals that we will then be serving. So that's kind of how we're thinking about it at a high level following the B2C success.

Niraj S. Shah

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

A

And Steve, this is Niraj. Let me just chime in. I guess, if you want to think about the B2B. Rather, you can maybe think about it as three phases. Phase 1 is where we just sort of do in a very light way – we have account managers, but that's really all we have, that we've already done that in Europe, but in Europe, as a result, only 1% of revenue versus round about 10% in North America.

Phase 2 is where you really operationalize that business, you're adding the selection, you have category teams, you're really managing the sales force. We've already done that in North America. That's what we're embarking on in Europe now. And Phase 3, which we're now embarking on North America is where you really go deep in these verticals, and you make each vertical bespoke experience. So just think of them as sort of like one follows the next, in the end Europe's like running one phase behind, but progressing on the identical kind of trajectory.

Stephen James McManus

Analyst, Exane BNP Paribas

Q

Okay. Thanks. And then just a quick follow-up. On International margins, any update on how we should think about kind of the cadence in the back half? And maybe a bit longer-term how international profitability is tracking versus initial expectations?

Niraj S. Shah

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

A

Yes. International is developing very nicely. I would caution is like, the problem with International is it's not really like a thing, right? This is like international with Canada and it has the UK and has Germany and we add them together, we call them international. But very different life stages. And just even if you zoom in on Europe, we first – we headquartered in Berlin because our goal was to build a broad European business.

The first market we focused on is the UK. We're the leader in the UK. The UK is sizably larger for us today than Germany. We're in the number one position. We have a household brand, teams based in Berlin. We only have 100 people in London. We have over 1,000 in Berlin. But once the UK was working, we then focused on Germany. Germany is now growing really well, but it's only a little over two years into the four-year cycle to build a household brand, but it's tracking very nicely. It's growing quite well.

So what happens is if you zoom in – for your question on profitability, if you zoom in, you would see the margin profile in the UK as meaningfully farther ahead than the margin profile of Germany. So these things sort of go sequentially. And so for the overall segment P&L to show the kind of profitability we have in the United States, that will take some time because you need the bulk of the countries in it to really be mature to the degree that the US is mature.

Stephen James McManus

Analyst, Exane BNP Paribas

That's helpful. Appreciate it, guys. Best of luck.

Niraj S. Shah

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

Thanks, Steve.

Operator: The next question is from David Bellinger with Wolfe.

David Bellinger

Analyst, Wolfe Research LLC

Hi. Good morning. Thanks for taking my questions. So first on passing through higher costs on to consumers. Are you anticipating some type of change in buying behavior near-term? If I recall correctly, I believe shoppers were taking a bit longer to convert after some of the tariffs went through a few years back. So are you seeing any early evidence of that now or other notable changes in buyer activity? And just any thoughts on how that could affect this holiday season?

Niraj S. Shah

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

You know, what I would say we're seeing consumer demand remain really high. Just to kind of give you some context, I mean, if you think about our business, 75% of our orders were repeat orders. So the business is really driven by people we already know. If you look at the active customer count, we have 31 million people in the active customer count. And if you're just looking at five quarters ago, we only had 21 million. So it's grown 10 million active customers in just the five quarters.

But in truth, the number of people come to our sites far more than that. One of the stats we gave out is that we had 4 billion visits last year. So if you think about the number of active customers, they wouldn't [indiscernible] (48:36), because – let's just run it this way. Say we had 100 million people visit last year that would mean they came 40 times each. Or if we had 200 million people visit last year, they would have come 20 times each.

So what's really happening in the business is you have a tremendous number of people coming and visiting regularly than buying on some frequency. We're not seeing any of the kind of delays you mentioned or whatnot. And in fact, we're seeing our brand get stronger. So I would think as you think about holiday, while we certainly could be buffeted around by the macro market. And so the question is like what overall demand levels are. I think you're going to see us taking share quite nicely as we roll through time. And then I think overall in the macro, we believe the macro market is – we think the summer is sort of a little softer, but we feel pretty good about where things are headed.

David Bellinger
Analyst, Wolfe Research LLC

Q

Got it. That's very helpful. And just a quick follow-up. Can you talk about what you're seeing in terms of labor pressures within your fulfillment centers or even at your suppliers' operations? Is that having an impact on timing and volume of deliveries? And at this point, are you building in some type of incremental cost into the business over the next few quarters?

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

A

Well, what I'd say there, the labor markets, no question, tight. I would say the congestion we see is more on the transportation side than it is on the fulfillment center side. But part of that is we've been very proactive. We've raised the minimum wage in the company widely to – the whole company minimum wage to \$15 and that was some period of time ago.

I think that puts us in kind of the bucket of kind of leading employers. And so I think as a result between the culture we have and the wages we pay, we're able to attract people fine. So we don't have a shortage in our fulfillment centers. I think the transportation congestion will take some time to play out, but we've been able to continue to access the transportation capacity we need so far.

David Bellinger
Analyst, Wolfe Research LLC

Q

Thanks, Niraj. Appreciate the color.

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

A

Thank you.

Operator: Your next question is from Steven Forbes with Guggenheim.

Steven Forbes
Analyst, Guggenheim Securities LLC

Q

Good morning. Niraj, maybe just a quick follow-up on the International segment. I think someone mentioned in the prepared remarks, right, that the strength was mainly a function of the delayed reopening cadence overseas. But anything to call out on a country-by-country basis in terms of the maturation of the business and what it tells you about the opportunity ahead? Because I think in general, the strength here was higher than expectations. Any sort of key metrics or data points we should think about for the back half strength just in that segment as a whole or on a country-by-country level?

Niraj S. Shah

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

A

Well, so as you know, we operate – we sell in four countries today, so the US, Canada, the UK and Germany. And I would say, what's happening in all four is very similar to one another, although the exact timing has shifted in each one sort of this way or that way by some period of weeks or months.

And so we're seeing the same cycles play out. And so I don't know that there's anything significantly to note. We're obviously a smaller player in some markets than others, which means we have a lower percentage of the total, which means we can grow at a faster rate more easily. But we're a small player in all of them. So the growth is really ahead of us in all of them, and there's no real thing to point to it. Michael, do you have anything to add there?

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

A

No. I think the only thing I would say is, as we've talked about the last few quarters, the UK business has sort of hit what we would call the sort of flywheel working really great. We feel really terrific about how that's sort of continuing a pace. And all of this is sort of ex-COVID where – just sort of like where we're at in those businesses, which I think is the question you were asking.

And Germany is coming up that ramp, but coming up in a really nice way. And I think in terms of the sort of the brand work we've done there, understand how customers are sort of seeing us and our brand and the investments we've made there, starting to see some really good payback in Germany. And so I think we continue to feel good about the entire International segment, as Niraj pointed out the couple of questions ago, each of those businesses is quite distinct, right. So we operate them as a segment that is the International segment, but they're all at different places in their maturation.

Steven Forbes

Analyst, Guggenheim Securities LLC

Q

And maybe a follow-up, sort of a bigger picture, right, as we think about the KPIs, specifically active customers. You talk about sequential change in – I guess, the slight moderation in active customers in the second quarter.

Is there anything that sort of would prevent the business from seeing sequential improvement from here on out? Or is that the international cadence or some other factor, right, still at risk here in terms of where the active customer base is in absolute terms?

Niraj S. Shah

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

A

Let me just jump in real quick, Michael, sorry, and then you please chime in. I think there's a math optical illusion there as well that I'd just point to. Q1 to Q2 of last year, we added 5 million active customers. The way the math works is if you don't buy for a 12-month period, you fall out of the number. And so as you noted, it goes down 2 million sequentially from Q1 to Q2. But Q2 year-over-year goes up by 5 million.

And it's that 12-month cycle with a particularly large jump up from Q1 to Q2 that makes the Q1 to Q2 of this year look a little odd. But if you zoom back out, the underlying trends are all very strong. You can see that in the repeat as a portion of total measure. And so you'll see the normal pattern kind of come back now that you're past that one-time blip from a year ago.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

A

Yeah, I was going to sort of say something similar. I think last year, during the early periods of COVID, on those first few quarters, we saw a much higher new customer growth. Not surprising, right? Folks were sort of trying us out for the first time. It's not surprising for us at all that some of those folks would fall out of that 12 months, right, that metric. The thing that's so important to remember, and I sort of harp on this all the time, is that's not how we actually manage the relationship with our customers, right?

So the fact that a customer purchased from us during that immediate COVID pandemic period in Q2 last year and hasn't purchased since then doesn't mean that they're not actively engaged on site, opening e-mails, putting stuffs in their idea boards. Like all of the things that we look to, to manage engagement is how we work it every day. And where we choose to sort of spend our ad dollars, and sort of how we want to be in front of the customer. And we have a lot of customers who might buy every 15 months. And those are really, really good customers, even though from an external reporting perspective, they fall in and out every 12 months.

Steven Forbes

Analyst, Guggenheim Securities LLC

Q

Thank you. Best of luck. Stay safe.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

A

Thank you.

Operator: And your final question comes from Chuck Grom with Gordon Haskett.

Chuck Grom

Analyst, Gordon Haskett Research Advisors

Q

Hey, good morning. Thanks. Just my question is on July and the slowdown that you've seen so far. And I'm just curious, if you guys could speak to how much you think you can attribute to seasonal timing versus a lack of interest in the home? And, Michael, I think you commented that this is going to be the murkiest moment of 2021. So I'm just curious, how you think the backdrop will unfold from here.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

A

Yeah. Thanks, Chuck. Let me say a couple of things and then Niraj can add in. The one thing, I would say about July, just to point out is, July was not markedly different than April and May and June. And so I want to be careful here in that the – there is – sequentially, we're sort of continuing to see, I think, over the last few months, a very similar level of engagement from our customers and sort of where the revenue is coming in, particularly when we look at it on a year-over-year basis.

And so I do think that you've got – it is murky because right now, there's a combination of macro factors are just really hard to read, right. The combination of folks are vaccinated, folks are out enjoying summer. Now, you've got variants, mass mandates, sort of the world is changing in sort of a very rapid way and how that's going to impact consumer buying behavior, particularly as we start to go into what I would call the sort of more regular season of people getting back into offices and back-to-school. I think it's just really hard to read, which is why we basically said, look, we think where we're at quarter-to-date is probably as good a read as we can give you.

Niraj S. Shah

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

A

Yeah. I don't have a lot to add other than knowing I would comment is, if you look at the shape of the revenue last year, you see this – COVID obviously starts in the United States in March, but you really see this acute spike that's sort of like heavy in May and then June, July, then it kind of like taper, it tapers over time. So a lot of year-over-year comps, I think, are not really great numbers to look at because you're kind of comparing them to a very nontraditional pattern a year ago.

So the actual year-over-year numbers look really weird. But what's really weird is actually last year's pattern, not this year's pattern. And so I think as you roll this year forward, I think you're going to see it play out the way you'd expect it to play out. And then I think once you comp that next year, you're back to more normal comps, but last year's comps are very unusual. So right now, the year-over-year doesn't – it looks very odd.

Chuck Grom

Analyst, Gordon Haskett Research Advisors

Q

Makes a lot of sense. And my follow-up would be – I was hoping you could speak to the performance of the customers that shopped you guys for the first time last year, perhaps in the first half of last year? And what their performance looks like relative to typical patterns?

Niraj S. Shah

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

A

This is one of the many things that gives us a lot of confidence about the business is we're seeing the behavior we would expect. And I try to cite this from five quarters ago. We're up 10 million on the active customer count from 2021 to 31 million from four quarters ago after the big spike up. We're still up 5 million active customers. So it's a huge number of customers that are still on the count, never mind all the other folks who haven't made, may not have bought in 12 months, but are still engaged with us and they're visiting the site and et cetera. That was my point about the number of business we had last year as an example.

And so I think you're going to see – this is one of the many, many reasons you're going to see this kind of normalized growth we've had historically, you're going to see that continue where we're doubling every two to three years. And that's where – in our investor deck, we have that one stat saying by 2030, we would be 8 times as big, \$112 billion. If you took some conservative assumptions around share shifting online, the share we could take, et cetera, and multiply them out. In truth, the numbers have actually been getting better. And so, the averages we used to end up being conservative.

So that kind of 8x, you'd actually expect to exceed that. And we have less than 2% share of our TAM right now. So even if you multiply the percentage of share we have by 8, you still don't have us being that biggest share owner. So there's a lot of headroom, and it's fundamentally sound because the offering keeps getting stronger, the customers are reacting very positively to it, and we're getting more and more customers.

Operator: I will now turn the conference over to the Wayfair management for closing remarks.

Niraj S. Shah

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

Well, I just want to thank, everyone, for joining today. We appreciate your interest in Wayfair, and we look forward to talking to you next quarter. Thank you.

Operator: This does conclude today's conference. You may now disconnect your lines.

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