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Wayfair, Inc. (W)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. Thank you for standing by. And welcome to the Wayfair Third Quarter 2021 Earnings Release Conference Call. At this time, your attendee lines are in a listen-only mode. After the speakers' presentation, we will have a question-and-answer session. [Operator Instructions] As a courtesy to all callers, please limit yourself to one question and one follow-up question, so that all callers may have a chance to ask a question. Please be advised today's conference is being recorded. [Operator Instructions]

It's now my pleasure to hand today's conference over to Director of Investor Relations, Landry Ngambia. Please go ahead.

Landry Ngambia

Director of Investor Relations, Wayfair, Inc

Good morning and thank you for joining us. Today, we will review the third quarter 2021 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 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 fourth 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 our 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, adjusted EBITDA margin 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 contain descriptions of our non-GAAP financial measures and reconciliations 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 and Co-Founder, Wayfair, Inc.

Thank you, Landry. And thanks, everyone, for joining us this morning. We are glad to reconnect with you today to discuss the details of Wayfair's third quarter results and to share more about the various initiatives on which we are focused.

In Q3, we generated \$3.1 billion in net revenue and over \$100 million in adjusted EBITDA. Though net revenue declined, this was not overly surprising given the quarter played out against the backdrop of customers eagerly embracing reopening trends, still having to anniversary an extraordinary moment of category demand last year, and supply chain issues becoming more pronounced this period.

Even so, we are seeing sequential acceleration in the year-over-year gross revenue growth rate in Q4 thus far, and product availability is improving, albeit slowly. As various geographies have reopened post pandemic, consumers have naturally shifted some spend towards travel and entertainment and from e-commerce towards brick-and-mortar. Demand and interest in the home remains resilient, but it will take a few more quarters for our growth and e-commerce growth in general to get back to normal.

Through this period of transition, we are not standing still. Those of you who know us will appreciate that we manage the business with a horizon of years, not quarters. Therefore, we are focused on making the necessary investments against ongoing strategic initiatives to deliver the best possible customer experience.

Our \$840 billion total addressable market is huge. We're already a leader in the category, and we plan to only widen our competitive moat.

While the macro situation may mean more financial volatility on a quarterly basis than we, and you, might have initially expected, we are fully convinced that we continue to make the right moves for the long-term.

I'd like to spend most of our time today on these longer-term initiatives, which focus on all aspects of Wayfair's platform model. However, first, let me address some of the supply chain issues buffeting the economy.

To put things into perspective, our product availability has improved versus the spring and is well above trough levels seen at the height of the pandemic. It's just not where we or the industry would like it to be or consider

normal. We feel reasonably well positioned into holiday and have built our promotional calendar to ensure adequate supply and sufficient lead times.

Still, it is true that the home category, like many sectors of the economy, is facing various supply chain bottlenecks that are resulting in inventory shortages, prolonged delivery timelines and inflation in both wholesale costs and retail prices.

Ripple effects from factory closures in Asia, ocean container shortages, port logjams, and a tight labor market are all factors that will continue to cloud the picture through much of 2022 even as governments and private enterprises mobilize to remedy them.

We too are doing all we can to mitigate these effects on behalf of our supplier partners and our customers. Many features that are natively built into our platform model helped in this regard. Additionally, we are also changing some practices to adjust to the environment.

Inherent to our model is Wayfair's expansive catalog of products and inventory-light approach, which helps preserve substitutability and customer choice. This is not a new feature and does not totally absolve us of losing out on some revenue if a customer decides to look elsewhere when faced with elevated out-of-stock levels on best-selling products.

However, it is an important dimension of the platform that we believe translates into a long-term competitive advantage vis-à-vis inventory-carrying retailers with markedly more narrow selections.

We're also adjusting some internal practices that became counterproductive in this environment. Specifically, Wayfair did not sell items that were currently not onshore in either our or our suppliers' warehouses. And therefore, we've listed these items as out of stock to the customer.

In the current environment, customers have come to terms with much longer lead times on products, and we need to adjust to that. We're just now beginning to sell products that we know are in transit, including those goods that are on the water. In doing so, we are estimating delivery timing further out and using that to level set customer expectations.

Another important feature of the Wayfair model, especially at times like these, is our international supply chain, which we now call CastleGate Forwarding. This is a set of services and freight forwarding capabilities which translate into ocean container availability at competitive rates for our suppliers, something they would not consistently be able to unlock on their own and which is particularly difficult to source today.

We're leaning in here in a big way. Our effective shipping capacity is growing multiple-fold year-over-year as supplier demand for these services continues unabated and our relationship building and large volume with ocean freight carriers is paying off. This long-term investment, which we started several years ago, is creating an ever more connected partnership between us and our suppliers.

As we speak, we are also simplifying the supplier value proposition for using our logistics services beginning to end, starting all the way in Asia and ending at the customer's room of choice.

Bundling the various services together in a cost-effective way aligns incentives with our suppliers to forward position products as deep into our network as possible. We expect this to drive further adoption and penetration

which should, in turn, increase product availability, speed of delivery and unlock greater efficiencies for our supplier partners and for Wayfair.

To be clear, there is no panacea solution for the supply chain challenges. It will take some time for the world economy to work through, but we're staying flexible and we're doing all we can to drive the best outcomes for our customers.

Wayfair also continues to look ahead while navigating these short-term issues. It's easy to become distracted by the current noise around us, so I'll now pivot to talk about the variety of initiatives we have underway that will translate into an even stronger competitive position over the years to come.

Wayfair's platform is fundamentally about connecting the industry's customers to the industry suppliers and delivering an easy and inspirational shopping experience that is tailored specifically for the home category. We do this through custom-built technology and infrastructure solutions across merchandising, logistics, customer service and supplier services.

On the other side of this transitory period and as the market resumes its structural shift online, we expect to return to historical growth levels as Wayfair translates these competitive advantages into share gains. I'll give you a sense of how we're expanding our reach and deepening our offering on a few of these fronts, reinforcing why our 2% market share in this nearly \$1 trillion market has substantial runway from here.

When it comes to customers, our focus remains on activating new or lapsed customers, while driving repeat among existing ones. In the U.S., brand and category awareness are important drivers of frequency. Our new, There's No Place Like It, universal marketing campaign emphasizes the emotional value tied to our homes and establishes Wayfair as the destination for all things related to it across all sets of classes.

We continue to innovate with ad formats. Via our apps, we recently launched Wayfair On Air, an initial set of influencer-led video content, which will grow into an on-demand shopping offering. Targeted print catalogs for Perigold and our specialty retail brands are also soon headed your way and emphasize shopping spaces, not just items. All of this is done via an ROI-oriented framework, consistent with how we drive our considerable ad spend.

In Europe, where the UK and German flywheels are nicely turning and under the direction of new executive leadership, we're laying the groundwork for our next set of geographic and brand extensions starting in 2022.

We have long said that any expansion will be methodical and built on the back of existing infrastructure, so you'll not be surprised to see our next country launches be into adjacent markets like Ireland and Austria. Over time, you should also expect us to establish a presence in other large European countries.

When it comes to merchandising, the pandemic has only underscored the fluidity between the online and offline worlds while shopping for the home. Online penetration for our category has substantial upside. Other categories, including consumer electronics and office supplies, has set the water line for online penetration at approximately 50%, while even the most established classes of home are only about 20% penetrated today.

That said, some customers clearly value the physical shopping experience. We saw this via our pop-ups in a mall-based store over the past several years. And the temporary swing back towards brick-and-mortar this summer was another interesting proof point.

These data points provide further validation for one of our key future ambitions, which is to establish a new kind of omnichannel shopping experience that blurs the lines between the online and offline. You'll begin to see that manifest starting next year.

We're embarking on this next phase of physical retail experimentation by establishing multiple formats for our family of brands. We'll take the time to test into the winning format and then scale as we've done before with other initiatives.

To spearhead our physical retail strategy, we've spent the last couple of years assembling a highly capable team of both externally and internally sourced talent and we're truly excited to begin to unveil what we've been working on in the next year and beyond.

As you know, our supplier partners are a critical part of our business model. We're building out tools and services to empower them to own their success on the Wayfair platform. To enable that, we have reorganized internally to modernize our partner home tech solutions, so that every supplier, regardless of size, can have as seamless an experience when partnering with Wayfair as our customers do. We're also unlocking the capability to welcome suppliers from all corners of the world onto the platform.

We now support suppliers in their native languages, including French, Spanish, Polish, Italian, Mandarin and, of course, English and German. Our follow-the-Sun service model also leverages our offices in multiple time zones, including Boston, Berlin and Shanghai.

On a personal note, it has been a real pleasure to meet with many suppliers in person over the past several months. Our teams have reunited at our offices where we've hosted multiple supplier summit events and also at several in-person trade shows. Nothing replaces the in-person experience, and we are feeling the benefits of that connectivity.

A pivotal part in our ability to work with a truly global set of suppliers is our end-to-end logistics infrastructure. We can take possession of products in Asia, break the shipments in bulk to go to different locations, arrange for transport over the water and to population adjacent fulfillment centers. We optimize the supply chain for our suppliers who cannot do it on their own. We also drive efficiencies in cost and speed that would not have been otherwise possible. This enables us to provide extraordinary service to our customers.

Part of our focus next year will be to drive even greater utilization through our network. New programming and incentives in 2022 should kick start our progress once again, which will only further accelerate as suppliers rebuild their inventory positions. This, in turn, should unlock the next level of efficiencies for our suppliers, our customers and for Wayfair.

Nearly everything we do at Wayfair is supported by a powerful backbone of custom-built technology. We already employ more than 3,000 best-in-class engineers, product managers, designers and data scientists and are proud to be a magnet for the tech industry's brightest minds.

We have significantly evolved and up-leveled our technology organization over the last year. To expand our employer reach even further, we're opening new engineering hubs across North America, in the Bay Area, Toronto, Austin and Seattle and are welcoming the next generation of technology talent to Wayfair in these locations.

You may now see that, despite short-term volatility and admittedly some macro murkiness, our long-term vision is, if anything, in sharper focus. The initiatives required to realize it are fully in flight even as we work through near-term macro challenges and consumer behavior continues to adjust.

The Wayfair model is resilient and built to scale. Our people are energized and our financial condition is strong. We are, as ever, focused on the long term, balancing strong growth and profitability over years, not quarters, and solidifying our position as the definitive destination for the home.

With that, I'll now turn it over to Steve.

Steven K. Conine

Co-Chairman, Wayfair, Inc.

Thanks, Niraj. And good morning, everyone. I'm excited to provide an update on Perigold for you today. We continue to see real strength with our higher income customers and Perigold is a core part of our luxury appeal. Our success here is also a good reminder that we have built our platform to extend beyond just Wayfair.com and to support a family of brands that span various styles and customer profiles.

We first launched Perigold four years ago as our luxury home brand and shopping destination, drawing on the insight that this part of the category was underserved and rapidly growing. Across the industry, households with over \$200,000 of annual income have grown their spending on home furnishings by more than 40% since 2017.

We estimate that high income households in North America now spend more than \$80 billion on the home category annually. There are also new tailwinds here as many of these customers upgraded to larger spaces or second homes over the last 18 months.

With Perigold, we have created a platform for consumers to learn about, engage with and ultimately bring home the world of luxury design across every style. Leveraging our technology, logistics and merchandising expertise, Perigold has seen tremendous growth with a revenue CAGR of more than 70% since 2018, alongside strong bottom line economics.

Historically, the industry's luxury selection was accessible in only a fragmented way, the exclusive showrooms and through interior designers. Our key focus with Perigold is to unlock the whole of the industry's luxury selection across all styles complemented with content on one digital platform, whether a shopper is working with a designer or not.

While many brands were initially hesitant to make the leap online, today, more than 1,300 suppliers embrace Perigold as their showroom. That's nearly 2.5 times as many suppliers as when we last spoke about the brand back in 2019.

Early on, we invested in the technology to help suppliers translate their physical products into a digital selling environment, with visualization tools and online merchandising strategies.

The COVID period underscored to luxury suppliers the importance of e-commerce, and Perigold stood out as a natural platform for them. We have now grown to more than 350,000 SKUs across the catalog, which is up by almost 50% since 2019.

We've expanded our class selection to include items like tile and appliances, and you'll see us continue to build presence in areas like recreation, outdoor and seasonal decor. Shoppers come to Perigold looking for a wide

selection, but also rely on us to put in the thought, time and effort to curate the best products for all their needs across their homes.

One important initiative we've been focusing on recently is a full redesign of the Perigold site, which started rolling out just last month. We have heightened our focus on presenting imagery of designed rooms across the site, bringing to life the range of high-end styles that the catalog offers.

This past summer, we also launched our Design Council, giving shoppers inside access to inspiration, interior design ideas, product decorations and more from some of the world's leading tastemakers. These enhancements are the most visible part of a suite of initiatives that help drive sequential improvements in SKU conversion rates in Q3. We encourage you to visit our Perigold site and app, and to experience the elevated aesthetic, luxury brands and customer appeal for yourselves.

We are very focused on the customer's full shopping journey and are putting thought against each component of their end-to-end experience. From our first interactions with potential shoppers, our marketing strategy employs a similar payback-driven approach as the rest of the business, but ensures we speak to the customer in a way that resonates with their unique interests.

For example, we just launched our first Perigold physical catalog, which features products across a range of categories and gives our shoppers a physical touch point they can come back to for inspiration on their own schedule.

The post-order customer experience in luxury is just as important as the product discovery and inspiration phase. The bar for high-quality delivery and customer service is even higher than it is for the mass market, and we are becoming more intentional about what happens post order while leveraging the very strong foundation we already have in place as a company.

Over the course of this year, we dedicated parts of our customer service organization to Perigold to ensure that customers get the white glove treatment they expect. We are also experimenting with a specialized design team to support luxury shoppers and to assist them in realizing their visions, both at the room and item level. Early results from these initiatives have shown a very positive reaction, with higher engagement and larger basket sizes.

As you can see, we are upping our game across all aspects of Perigold, and we can't wait to share what is coming in the future. We just hosted our Perigold Supplier Summit to dive deeper into our go-forward strategy and to reinforce the close partnerships with our luxury supplier partners.

You heard Niraj speak earlier about some of our vision when it comes to new frontiers for Wayfair. And we expect Perigold and these suppliers to play a meaningful role in our future growth.

With that, I'll turn it over to Michael.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

Thank you, Steve. And good morning, everyone. Let's take a look at the financial details for the third quarter, before discussing the forward outlook. As you saw in our press release this morning, Q3 total net revenue was \$3.1 billion, representing an 18.7% decline year-over-year.

The quarter played out largely in line with our preliminary read back in August. During the early months of the summer, we started to see a rebalancing in consumer spend towards services as the US economy more fully reopened. As the summer progressed, our international markets followed the same pattern on a staggered basis, which contributed to the quarter-over-quarter softness in Q3.

On a segment basis, U.S. net revenue declined 20.8% from Q3 2020, while International net revenue declined by 6.8% year-over-year. On a constant currency basis, International net revenue was 12.1% lower than Q3 last year.

Turning to the Q3 KPIs at the consolidated level. In the trailing 12 months, we had more than 29 million active customers, 1.5% higher year-over-year. Order frequency over the last 12 months was 1.92, essentially flat year-over-year. Both of these metrics were lower quarter-over-quarter, which was expected given the outsized customer activity during lockdowns last year is now rolling out of the LTM window. This is similar to what we saw in Q2.

LTM net revenue per active customer was up modestly, about 1% quarter-over-quarter, but there is admittedly a fair bit of volatility underneath this metric. Specifically, offsetting the small declines in order frequency is a move higher in average order values. As you know, bottlenecks are contributing to inflationary pressures at nearly every point in the supply chain. We, like the rest of the industry, are working to pass these costs through, where appropriate, which is what you're seeing play out in AOVs.

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. I will use the same non-GAAP basis when discussing our outlook as well.

Q3 gross margin was 28.4%, just slightly ahead of our guided range. As anticipated, gross margins have come down sequentially as volume levels have begun to normalize and as we remain thoughtful about which inflationary elements to pass through versus absorbed in the shorter term.

Customer service and merchant fees were 4.3% of net revenue in the third quarter, just slightly ahead of our guided range, primarily due to increased compensation costs. Advertising as a percent of net revenue was 10.1%. Online advertising markets are adjusting post reopening and in part due to iOS privacy-related changes.

We are staying disciplined and sticking to our ROI-driven framework across all major channels, while our marketing colleagues also focus on unlocking efficiencies via new ad formats and channels.

Our selling, operations technology and G&A, or OpEx expenses, totaled \$418 million, which was below our outlook. The pace of net hiring was once again a factor in a tight labor market. Though, I'm pleased to report that after mobilizing extra recruiting capacity earlier this year, we are now making headway and catching up against our hiring intentions. This is something OpEx dollars will start to reflect in Q4 and beyond.

Putting this all together, Q3 adjusted EBITDA was \$101 million or 3.2% of net revenue. In the U.S., adjusted EBITDA was \$167 million at a 6.4% margin, while the International segment booked adjusted EBITDA at negative \$66 million.

Moving on to the balance sheet and cash flow. We ended the quarter with \$2.4 billion of cash and highly liquid investments. In Q3, net cash from operating activities was negative \$131 million and free cash flow was negative \$203 million after factoring in \$72 million of capital expenditures.

You'll note that a swing in net working capital drove the operating cash outflow, something we flagged would be the case given the sequential deceleration in net revenue. This dynamic should reverse as revenue dollars grow over time.

Turning now to our outlook. The macro environment is clearly still very fluid. It will take a few quarters to really settle out in terms of getting a clean read on customer behavior, the longer-term state of the global supply chain and ongoing impacts of inflation, including a higher cost for talent.

In this context, we, as a management team, are being very deliberate about making sure we have a firm grasp on what's happening, making adjustments when required, some of which we've spoken about today, and are also making conscious choices as it relates to pushing on longer-term initiatives. That said, if our assessment of what's happening in this macro environment changes, you can expect us to continue to adapt and make trade-offs as we deem necessary.

As we move into the holiday period, we continue to expect Q4 net revenue dollars to be above Q3 levels. On an orders placed basis, quarter-to-date, our consolidated gross revenue is down approximately 10% year-over-year. However, Wayfair.com in the US is trending down only modestly.

Though we've seen some improvement in growth rates year-over-year thus far in the quarter versus Q3 trends, we are in a mass-oriented business where the average customer does not have an unlimited discretionary budget. Inflation is rampant across the economy and there are competing demands for their time and wallet share.

We're watching closely to make sure the customer shows up every day. In light of the various cross currents influencing consumer behavior, a prudent modeling assumption would be to not project further improvements in trends for the rest of Q4.

Given the large scale of our business and the tailwinds we experienced through the height of the pandemic, it will take a couple of quarters until we have fully lapped COVID-enhanced demand and return to year-over-year growth.

When it comes to gross margins, we continue to see 27% to 28% as a sustainable range for us, with continued visibility towards longer-term expansion. However, the low end of this range is a more appropriate place for you to model for Q4.

Even with the benefit of operational efficiencies and supplier services ramping nicely, a tight labor market and higher wholesale and third-party shipping costs are all acute near-term factors that we have to work through.

We forecast customer service and merchant fees as a percentage of net revenue will be in line with the Q3 levels. 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 and related taxes, should be approximately \$470 million to \$480 million in Q4. Our annual compensation and promotion adjustments took effect in Q4 as we make sure our valued employees are competitively compensated.

We are also now making progress against net hiring goals after a slow start to the year. Technology costs, primarily related to our continued migration into the cloud, are another driver here. Assuming the top line trends we've seen quarter-to-date continue, this would translate to a near breakeven adjusted EBITDA outcome in Q4.

To build on Niraj's remarks, I want to acknowledge that we are actively accepting some quarterly financial volatility, so as to stay the course as it relates to our longer-term strategy, and we will not manage to a particular margin level in any single quarter.

You have all seen the underlying margin potential of Wayfair over the past several quarters, and we expect to have some patience in getting back to those peaks and ultimately beyond.

The bottom line recovery will accelerate as we get back to more normal levels of top line growth. We remain focused more on full-year results for 2021 and 2022 as those will be far more telling than any particular quarter.

Touching now on a few housekeeping items. Please assume the following for Q4. Equity-based compensation and related tax expense of approximately \$111 million to \$113 million; depreciation and amortization of approximately \$78 million to \$83 million; interest expense of approximately \$8 million to \$9 million; weighted average shares outstanding equal to approximately 105 million shares; and we expect CapEx in a \$65 million to \$75 million range, subject to timing.

We are maneuvering through a complex macro situation. Year-ago comps cloud the picture. Consumers are still finding their new normals. And we are closely watching how supply chain challenges and inflationary pressures across the economy might impact our core mass market customer.

In this environment, we remain laser-focused on our customers and our suppliers, who are core to the Wayfair platform. As you heard, we are highly connected to both sets of stakeholders, responsive to their feedback and nimbly adjusting our practices when the situation merits.

Yet the long-term opportunity remains unchanged. This is a vast and complicated category and winning in it requires scale and a long-term mindset. Next year will mark Wayfair's 20th anniversary and we're building for the next two decades ahead.

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

QUESTION AND ANSWER SECTION

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

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

Hi. Thanks. Good morning, everyone. I wanted to ask around the inflationary pressures as it might relate to some changes in pricing with Wayfair.

So, based on our supplier conversations and some of our own analysis, it looks like there has been a decision to raise prices, even to a point where you're a little bit above the competition. So, I was wondering if you could unpack that a little bit. Obviously, you have the house brand strategy, which should allow you to take price. But are you concerned about losing share in the current environment with this?

Niraj S. Shah

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

A

Thanks, Peter. Let me answer that. But let me start with just a real quick recap on how we think about setting prices. And I think that's important. So the way we do it, I think, is different than the way most retailers do it, in the sense that we don't have individuals who are picking margin levels for categories or subcategories.

Instead, what we do is we have a large data science model and it is basically figuring out what tranches of the catalog to set at what margin levels. And it does it off the concept of really understanding consumers' demand response to pricing changes.

And what we're really focused on is not so much substitution because we view substitution as an advantage of our platform, which is someone might buy one item instead of a different item based on how they're relatively priced. But rather, what we're focused on is, how do we make sure that customers stay on our platform and the price levels aren't such that they want to leave and go elsewhere. And over the years, we've been able to make that more and more sophisticated.

We're constantly running holdout tests and control tests to basically make sure that the algorithm is well tuned. And that kind of science-based agenda has actually gotten us, we think, to quite an advantaged place.

And so, you'll notice, when you talk about national brands where something has a specific part number, you know you have to be basically at market, the algorithm sort of does that. And at the same time, to your point, we need to have exclusive brands, house brands. We have items that maybe [Technical Difficulty] (0:35:24) platforms. We have items that we invested a lot into the merchandising of and identifies that as well.

The point, I guess, I want to make is we, over the last four, five years, have had this agenda on how we can unlock a lot of gross margin. We're talking about 1,000 basis point runway, and this was back when we were at 24% to 25% gross margin. We talked about how logistics could unlock a lot of savings. We talked about how the merchandising could unlock a lot of savings, how the volumes going through the platform allows suppliers to lean in with better pricing and still make the margin they want. And we talked about how supplier services play an increasingly large role.

And I think what you've seen happen is that we've been successful at unlocking margin. And frankly, as we look forward, we think there's a pretty solid road map of unlocking a lot more. And as we do that, that actually provides customers with – excuse me, customers with lower pricing while also accruing margin to us. So, I think where we sit today, we feel – I'm sorry, just some more water. So where we sit today, we actually feel pretty good about price levels overall and the road map we have to keep being more and more sophisticated, we feel very good about as well.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Okay. Thanks so much. Maybe I'll ask a follow-up and maybe for Michael in order to get your voice back. The one thought we've had around with CastleGate, certainly, it's a huge long-term opportunity. But with revenues running down and supply chain and inventories very, very tight, are you at a point where the CastleGate flow is actually running down on a dollar basis and, thereby, could this continue to put some margin pressure on you as you deleverage some of the fixed costs within the network.

Niraj S. Shah

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

Peter, let me just chime in on CastleGate before I hand it over to Michael for your kind of the financial aspect question. CastleGate, the inherent advantages of CastleGate between our ability to access ocean freight at a competitive price and get availability in a congested time all the way through to our ability to forward position and, therefore, offer customers both speed of delivery while the outbound cost actually falls, all of which manifests also in customers getting sharper retail, those benefits have actually been very – kind of a very nice bright spot through this period. The fact that we built this network has proven to be quite a boon.

That said, the mix effect, basically scarce inventory, has caused CastleGate to have lower inventory levels and run at a lower percentage of the total business than it was pre-pandemic.

When we look forward to 2022, suppliers are now seeing inventory levels recover. We're seeing inventory levels recover. We have more ocean freight capacity. What you're going to see happen is we believe CastleGate penetration will hit all-time highs and actually kind of meaningfully continue to expand. Some of this is what we talked about on the call about how we're bundling these services together, make it easier for suppliers, and some of it is suppliers are also seeing the forward positioning with the carrier congestion being something that they can't avoid on their own. They need to partner with us because we have that dense network. We can do different forms of sortation and injection.

So CastleGate, as you roll forward through time, not only are they kind of on a unit basis, is it already showing that it's very beneficial, but as we roll through time, mix actually goes from hurting us to helping us, and it's actually I think you're going to see it be fairly dramatic in its benefits.

But let me turn it over to Michael to kind of answer your question.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

Yes. Peter, the only thing I'd add is, look, obviously, if you have a warehouse operation, you're running a little less through it, then there is some deleverage there. But I think you've seen the continued strength in our gross margin, right? And so, the north of 28%, north of our – the high end of our range this past quarter and staying within our range for next quarter.

And so, as Niraj points out, there's many pieces to the supply chain where leverage happens, right, ocean freight is another example. And so, I think as more – think about it this way, as more suppliers now start to load more inventory into CastleGate, they're taking advantage of that ocean freight. That's an opportunity and creates leverage for us. And then, as those units flow into the building, we'll flow more of them out of the building and will create leverage back on there, too.

So I think it's – remember, CastleGate and this entire supply chain network is a long-term investment with massive ROI. And so, I don't think you can sort of look at it as sort of in any one particular quarter.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Okay. That's helpful feedback. Thanks so much and good luck.

Niraj S. Shah

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

Thank you.

Operator: Our next question will come from the line of Oliver Wintermantel with Evercore ISI.

Oliver Wintermantel

Analyst, Evercore Group LLC

Hi. Good morning, guys. Thanks for taking the question. Very excited to hear about your multichannel strategy. Maybe, Niraj, I know it's early, you will announce more next year. But maybe after you gave us a little teaser, can you maybe give us a little bit more detail as to what you're planning to do? You said it's across the family of brands, but maybe a few more details would be helpful. Thank you.

Niraj S. Shah

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

Yeah. Oli, great. Let me just share a couple of thoughts on physical retail. So, the first thing I would say, which I kind of covered in the script is, we kind of view ourselves as in year four of the journey where the first couple of years had to do with pop-up stores and malls. Then we had a permanent store in the Natick Mall, small one though, 5,000 square feet, 3,700 square feet front of the house.

And in each step along the journey, we feel like we had a learning agenda that we were able to complete and maximize which sort of lead us to now – we sort of – we have some ideas for different concepts that we think could be the late concepts that we would then want to scale.

And so, what we're going to do, you're going to see this over the next two years, we're going to launch a series of these different concepts and we're going to see, by getting a couple of each up and running, how they perform in the real world. And then there's a series of different things we want to try in them, kind of what I was referring to as a testing agenda that we've been doing all along the way.

And if you think about stores, the cost – there's obviously the cost of a store, but typically, the big costs that are associated with that are also the cost of the physical supply chain to enable the flow of goods and delivery, the cost of the inventory in the supply chain and the cost of whether you want to call it advertising or marketing or

building a brand, but the cost for someone to know who you are and to kind of understand why they would want to visit.

And I think what's interesting is those latter three are things that we already have effectively spent the money on. We have a household brand. We have tens of millions of customers who we e-mail every week. We have a supply chain that's quite vast that enables fast delivery to customers everywhere that is full of inventory. Our suppliers own that inventory, but just seems available for immediate delivery.

So, all of a sudden, you start thinking about, man, if you get that store right and it's just another channel you've added into the mix, in addition to the stories you tell on TV and what you're doing on social media and what you can do with catalogs, what you do online, you can start to see, well, man, that's quite a nice leverage point, roll it forward, one day, it's 50% online, 50% offline. Well, jeez, you're now getting to participate in that 50% offline that you wouldn't otherwise.

So we're pretty excited about it. We think these concepts make a lot of sense. We've hired up a very seasoned team of folks who have significant physical retail experience. It's quite a substantial team, and we've made sure that a number of internal Wayfair folks who have a lot of expertise have transferred over to that team.

And so, when we talk about having thousands of people working on things that don't impact the P&L today, this is just one of many different efforts that would total up to that number of people. And so, it's – we're pretty excited about it and you're going to see the concepts roll out against – starting early next year through 2023.

.....
Oliver Wintermantel

Analyst, Evercore Group LLC

Q

Got it. And just to clarify, so these would be real – like, stores with inventory, not just showrooms or pop-up stores.

.....
Niraj S. Shah

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

A

Yeah. They would be permanent stores, so not pop-ups. Obviously, you have the inventory that's on the floor. So you have like the – whatever you want to call, the showroom itself. And then, for inventory that people could take with them, if you think about our categories of goods, there are certain items people might want to take with them. It's going to over-bias on the smaller items. When we get to the bigger items, we would expect they would want those items to be delivered. So there'd be a mix. We think the vast majority of the volume would be set up for delivery because of the nature of the categories. And that's where when you think about the fulfillment centers we have, if you think about the delivery operations we have, that would just flow through an existing infrastructure we already have that's set up for that. And that infrastructure doesn't care whether the order was placed in a store, or the order was placed over the phone, or the order was placed online. It's an order that we'll deliver. But, of course, for smaller items, we would, of course, enable cash and carry as well.

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Oliver Wintermantel

Analyst, Evercore Group LLC

Q

Got it. Thanks very much and good luck.

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Operator: Thank you. Our next question will come from the line of Seth Basham with Wedbush Securities.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

Thanks a lot and good morning. My question is around how you're thinking about customer acquisition in this environment. Your customer acquisition costs in the third quarter were some of the highest ever. And given the challenges to acquire new customers and the cost of it, how are you thinking about managing that in the current environment?

Niraj S. Shah

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

A

Yeah, Seth. So, let me just kind of recap how we think about advertising because I think the way we've managed it historically has proven to be a great benefit. And we're sticking with that approach, which is simply we don't preset a budget. But rather, what we do is we effectively tell our marketing organization, they have an infinite budget. However, we're very inflexible and have a very tight framework on measuring paybacks. And they have to keep it within that payback framework.

And that payback framework is what makes sure that we don't find ourselves down the road having overspent on cohorts that will never pay back. And then, frankly, it has a secondary, but perhaps even a more beneficial role, which is by keeping that constraint tight, what it does is, then the teams put a lot of effort in developing new channels. There's things like influencer marketing or podcasts. There's a lot of channels we're not in today. Or technology – advancing the technology platform or better targeting or creative optimization. And these things are the things that lead to breakthroughs where we get increasing reach, more and more effectiveness of our ad spend and we're able to grow the ad spend really productively.

We have noticed what you've noticed, which is there's inflation out there. We've been careful not to chase it. And the reason we don't chase it is we generally feel like we know how to quantitatively measure the value of that traffic. And we notice competitors who chase it tend to, in the not-too-distant future later, stop doing that because they find – they figure out that they're overspending. And we've, in fact, seen some of them already pull back. So, that's a common cycle. And we feel like it behooves us not to chase.

And in fact, if you look at our ad spend and you kind of adjust for the repeat orders, which obviously – keep taking share because that's the strength of our model. Happy customers come back, that repeat order growth is what drives the overall growth of the business, which is why we can keep doubling every two to three years. If you look at that and adjust for that, you'll find that our customer acquisition cost remains in the range that we've had, if you look back over the last few years, and we're still paying back in that same timeframe, less than a year. And we think that discipline behooves us, even if there are moments where someone is outspending us.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

Got it. So, just to clarify, since the beginning of the pandemic, your LTV to CAC that you're projecting for the customers you acquired during this past period has not changed much. And as you look at the near-term, you're willing to accept fewer new customer adds in light of higher customer acquisition costs that may make those ROIs unfavorable?

Niraj S. Shah

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

A

Yeah. Well, I'll go a step further. Not only has the payback period since the beginning of the pandemic not changed, but frankly, if you zoom out even longer than that, we've kept the same high-level framework on paybacks for quite some time.

And if anything, we've only tightened it a little over time as we've been able to get more nuanced in how we account for cost. So, that's not – we continue to tighten that up, but basically that – what you're saying is true. We've kept it – since the pandemic started, yes, we've kept it very tight.

The thing about LTV to CAC, I'm talking about the payback, right, so they have in roughly a year. If you zoom out and you really try to calculate a lifetime value, three years, five years, pick a period, you'll actually find that the LTV, the IRR is increasing because what you're seeing is repeat gets stronger as people come back more and more often as you look at years two, three, four, five. If you would calculate that in, which, of course, you wouldn't know until you can look back on years two, three, four, five, you would actually see the IRR then is increasing because we don't give that credit in that first year. Only give credit in that first year is what actually happens in the first year. So, if year two of a cohort is stronger than year two used to be, you're actually seeing an ever improving return on your ad spend, but we won't put that into the first year. And so, we will, therefore, not put that into the ad spend.

Seth Basham

Analyst, Wedbush Securities, Inc.

Thank you.

Steven K. Conine

Co-Chairman, Wayfair, Inc.

Thanks, Seth.

Operator: Our next question comes from the line of John Blackledge with Cowen.

John Blackledge

Analyst, Cowen and Company

Excuse me. Great. Two questions. First on the international expansion. Can you discuss the timing of the launch of Wayfair in Ireland and Austria and should we expect other launches in Europe in 2022?

And then, for Michael, on 4Q revenue, what's the difference between the consolidated revenue pacing down 10% and Wayfair U.S. being flattish? If you could just provide some more color there, that would be great. Thank you.

Niraj S. Shah

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

So, let me try to answer those, John. And then maybe, Michael, I don't know if Michael would have any additional or Steve, they can jump in.

On international launches, the reason we highlighted Ireland and Austria, over time, we certainly would expect to be in more countries. But the same way we took the infrastructure we had in the US and we leveraged it for Canada, an adjacent market, more underserved, smaller market.

If you think about Ireland related to the UK or you think about Austria related to Germany, you have that analogous situation where you can actually pick up that volume, become the market leader much more quickly.

It's a great way to start your expansion. Over time, we will certainly expand to other countries. But we were just more trying to point out what's going to happen next, which is what Ireland and Austria are when you think about next year.

And then, on your fourth quarter revenue question, I think what we were trying to do there is provide a couple of pieces of insight. So, one is, look, quarter-to-date, we're down around about 10%. And I think we sort of said – and that number is actually sequentially improving, and that's just to give you a directional feel for where we're headed. And as you kind of get through these kind of COVID periods from a year ago, and so if you kind of look to the – to kind of the future a little bit, you, all of a sudden, start seeing you're comping normal periods, all of a sudden you're going to see those growth rates that tell you you're doubling every two to three years. So, we're just trying to tell you where we are in that journey.

The only reason we commented on Wayfair.com is we generally don't break out the whole business and try to tell you about every segment, and there's meaningful segments, obviously, the different countries, the different retail brands we have, the lines of business, professional versus the consumer side, was simply that a lot of times folks take our Wayfair Inc. number and they may compare it with someone where the more comparable number might be Wayfair.com, which is our US mass business.

And so, we said, well, look, it's a period of time where people are trying to figure out how things are going, where the directional trends are. So, telling you that Wayfair.com is only down modestly, the whole point was, hey, don't take the 10% and assume it's linear across the board. Each of the countries have a different time period of COVID happening. Europe is seeing another COVID surge. And you have these different things that are happening. And basically, let's just kind of tell you, the total company is down 10%. You kind of hear that number from us every quarter. And just to give you a little flavor, Wayfair.com, which is US mass, that's down very modestly. So, okay – oh, wow, okay. I was assuming that's down 10%, it's only down modestly. That's better than I thought. Okay, that's interesting. I've got to remember, you have a big and multifaceted business, each piece is a little different. That's all we're trying to say.

John Blackledge

Analyst, Cowen and Company

Thank you. Thanks.

Operator: Our next question is going to come from the line of Steven Forbes, Guggenheim.

Steven Forbes

Analyst, Guggenheim Securities LLC

Good morning. Niraj, you mentioned the thesis of selling spaces, not just items. So, curious if that's centric to just Perigold or if you see an opportunity within the Wayfair brand as well in those underserved households.

Niraj S. Shah

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

Yeah. Thanks, Steven. No, we see it for the Wayfair brand as well. We see it for our specialty retail brands. The design services offering that we have inside our B2C sales team where we work with customers leads to multiple item purchases and thinking of projects.

If you look at what we're doing in home improvement, if you think about what we have between the categories, flooring and tile, lighting, plumbing, vanities, door hardware, large appliances, you can start to think about laundry

rooms, bathrooms, kitchens and those types of projects. We do those projects in addition to selling people just items, right? So we do both. So we see it applicable broadly. Obviously, Perigold is very applicable.

And then we think about Wayfair Professional, we have a series of verticals, a lot of whom have to do with projects. The interior design decorators there, obviously, the decorator is doing a lot of the work, but then our team can provide a lot of support and help.

And then, of course, we have the resource catalog. We have the logistics ability to help them. Then when you get over to – whether it be contractors who might be referring their customers or you get into what we do in hospitality where we've outfitted entire boutique hotels, there's a lot of project work in these various different segments of our business.

Steven Forbes

Analyst, Guggenheim Securities LLC

Q

And then just a quick follow-up, maybe for Steve on Perigold. You talked about sort of the strength in that brand over the past couple of years here. Curious if you could give us any insight or data on how many high income households are – you're engaging with the platform? And then, maybe what the average order value is on Perigold relative to Wayfair as a whole?

Steven K. Conine

Co-Chairman, Wayfair, Inc.

A

Yeah, thanks. Yeah, so we're not going to give real specific detail on Perigold at this point. But since we first talked about in 2019 to where it is today, we've really seen very nice growth in it. It's still early. I think our penetration in that category is quite low. The high income luxury customer, we feel like is quite underserved and the Perigold offering is really key for them and who we're going after.

Niraj S. Shah

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

A

Yeah. [indiscernible] (0:53:53) I would just add, Steve, to say to your point, the AOV is certainly many times higher than that on Wayfair, which I think is, it appears, you're asking. It's definitely – we don't disclose the exact number, but it's multiple times higher.

Steven Forbes

Analyst, Guggenheim Securities LLC

Q

Thank you. Best of luck.

Steven K. Conine

Co-Chairman, Wayfair, Inc.

A

Thanks, Steven.

Operator: Thank you. And with that, I will end the Q&A session. I'd like to turn the conference call back over to the Wayfair team for closing comments.

Niraj S. Shah

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

Well, thanks, everybody, for joining the call. We are excited to chat with you. Happy holidays to all of you, and we look forward to talking to you again next quarter.

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

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