03-Nov-2022

Wayfair, Inc. (W)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the Wayfair Third Quarter 2022 Earnings Release Conference Call. Please note, today's conference is being recorded. [Operator Instructions] Thank you. At this time, I will turn the conference over to James Lamb, Head of Investor Relations. Mr. Lamb, you may begin your conference.

James W. Lamb
Head of Investor Relations, Wayfair, Inc.

Good morning and thank you for joining us. Today, we will review our third quarter 2022 results. With me are Niraj Shah, Co-Founder, Chief Executive Officer and Co-Chairman; Steve Conine, Co-Founder and Co-Chairman and Kate Gulliver, Chief Financial Officer and Chief Administrative Officer. We will all be available for Q&A following today's prepared remarks.

I would like to remind you that we will make forward-looking statements during this call regarding future events and financial performance, including guidance for the fourth quarter of 2022. 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 2021, 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.

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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 & Co-Founder, Wayfair, Inc.

Thank you, James, and good morning, everyone. We're glad to reconnect with you today to share the details of Wayfair's third quarter results. This past August marked our 20th anniversary. It was in the summer of 2002 that Steve and I first started this business out of a nursery in Steve's home.

We were still nearly a decade away from adopting the Wayfair name at that point. But since the beginning we've had a vision of creating a premier online shopping destination for the home. We thought big and bold every step along the way, and for nearly a decade, we were able to self-fund our growth as we reinvested operating profits back into the business.

In 2011, we rebranded as Wayfair, and for the first time, raised outside capital as we look to scale up our growth. In the decade since, we've grown the business by nearly twenty-fold and made meaningful investments in building out our catalog, customer file, geographic presence, logistics platform and more.

With the size and scale we've achieved, we are now in a position where we can operate the business for both profitability and growth and are well on our way to returning to a state of self-funding once more. Last quarter, we talked about controlling the controllables and orienting Wayfair in this environment around three key principles: driving cost efficiency, nailing the basics and earning customer and supplier loyalty every day.

Kate and I will talk through what we're doing on each of these fronts, and I want to begin at the top. When we spoke in August, we framed what our path to profitability would look like and told you that there will be more detail to come in the not-too-distant future. You saw the first evidence a couple of weeks later as we made the decision to eliminate nearly 900 corporate roles across the organization.

Our goal here was to reduce redundancies and remove excess management layers as part of an organization-wide effort to streamline our operations. At the same time, we talked about additional reductions coming from our spend on third-party labor. These two components represent just one set of actions in the cost efficiency [ph] program (00:05:00) that we are executing. Simultaneously, we kicked off a separate set that involves operational initiatives such as returns monetization, scam reduction, incident prevention, logistics optimization and more.

Let me provide just one example by further illustrating returns monetization. When we process a return today, there are complexities involved with the cost to send the product back and how we can merchandise and resell it after the return. We see an opportunity to improve the accuracy of our grading to increase open box sales through platform and pricing improvements, and to decrease shipping expenses by changing how we manage logistics.

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This initiative alone should result in tens of millions of dollars of savings and is one of numerous operational improvements we are working on.

Altogether, we expect the actions we've taken so far to drive over $500 million of savings in our P&L. And as you will hear from Kate shortly, there is more coming. Our goal across the board remains the same as it has been for most of the year. Returning to adjusted EBITDA breakeven quickly in 2023 before targeting positive free cash flow shortly thereafter. From there, we will drive towards a mid-single-digit adjusted EBITDA margin level that we will philosophically treat as a lower bound of profitability for the business.

As we discussed last quarter, this threshold will allow us to cover off other costs, such as stock-based compensation as well as CapEx associated with logistics investments and capitalized software. As we look to the future, this foundation will enable us to not only drive continued investment into the big and bold ideas that we have planned for Wayfair's next 20 years, but also deliver profitability in a consistent manner.

I want to turn now to the notion of nailing the basics, which means showcasing products that interest the customer, providing a great experience on the site and delivering perfect orders that arrive quickly. Key to these commitments are elements such as assortment, availability and speed of delivery, all of which have improved significantly from where we were a year ago. In particular, several speed metrics reached records in Q3, including days to deliver and speed badge penetration.

Another part of nailing the basics is ensuring we have a clear and relevant promotional calendar to engage our shoppers, which is especially important now given what we are seeing in the consumer environment. Inflation persists quite broadly and with spending pressure across the spectrum of discretionary goods we continue to see shoppers being very discerning about where their next dollars are going. For much of the summer months, that discretionary spend shifted from goods to services with pressure felt across a wide array of retail sectors, including ours.

While interest in the broad home category remains, we are seeing shoppers being more deliberate with their spending patterns as they seek out great value and wait for promotions. As a result, promotional activity across the industry remains high and customers are responding very positively.

To support our suppliers, we have put together a very strong fall calendar of events. Last week, we ran a successful second Way Day, which came right on the back of our five days of deals event. And in just a few weeks from now, we'll get to the traditional Cyber 5 tentpole events. Each of these promotions is an opportunity to provide value to our customers and our suppliers, importantly, without compromising our gross margins, given our inventory light model.

In today's environment, it is more important than ever for us to remain focused on our next key principle, driving customer and supplier loyalty. So let me give you a few examples of how we're doing this. One of the biggest factors in driving customer loyalty is having a great experience at all stages of the shopping journey, even after their order has been delivered.

To do this, we have made an effort to equip our service professionals with an even wider toolkit of solutions to make things right for our shoppers, if as occasionally happens, an issue arises. These enhancements are generating a very strong response. In fact, over the last handful of months, we've seen repeat rates among customers who report an issue actually match repeat rates of customers, who do not.

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Our relentless focus on creating the best possible shopping experience is a key enabler of earning customer loyalty, and we're pleased to see these efforts validated by internal data, as well as external accolades. We're honored to share that our customer service team has been recognized by Newsweek in their Best in Customer Service 2023 rankings.

We also know our customers care about the environment, as do we. And we are continuing to innovate with programs to address sustainability. On October 20, we launched our Shop Sustainably program, Wayfair's third-party certified sustainable product offering. We now host the largest number of third-party sustainability certifications in the home industry as well as a refreshed set of options to filter for attributes like water efficiency, fair trade and more.

We're very proud of Shop Sustainably, because doing the right thing for our communities and our customers isn't a function of whether the economy is good or bad, but it's something we think of as our responsibility.

On the other side of loyalty equation, we have our suppliers. Since earlier this year, we've been encouraging suppliers to lean into CastleGate. And we've seen continued strong momentum. CastleGate drives multiple advantages for suppliers, faster conversion through quick delivery, lower retail prices due to ship cost savings, better visibility on site, reduced damage rates and more.

After the supply chain shortages of last year, suppliers are reengaging, and CastleGate penetration is now back to 25% of volume in the US and climbing. The benefits that CastleGate provides to suppliers result in tangible value to customers as well as creating a positive flywheel that will further drive loyalty from both groups into the future.

I want to wrap-up by returning to where we led off on the first of our key principles, cost efficiency. We are, as a management team, and as an organization, universally focused on taking the steps needed to reach adjusted EBITDA and cash flow neutrality in short order. We've taken a hard look at our cost structure holistically to identify areas of improvement and take action aggressively.

Our execution against these initiatives is thoughtful and deliberate to ensure that we can make progress towards our profitability targets, without compromising the potential in front of us. I will reiterate it once more, to be clear. We intend to reach adjusted EBITDA breakeven independent of what the macro brings our way. And from there, to move forward to our mid-single-digit margin target, which will allow us to cover our expense base, while at the same time funding our future growth.

Over our 20-year history, we've seen several economic cycles. One thing that Steve and I have learned is that moments like this present an opportunity to set ourselves up for continued success as a category leader. One irony is that this is when we're at our best. We built this business with no outside capital and beat very well-funded competitors. We know how to win by being both lean and focused.

Thank you. And now I'm excited to turn it over to Kate for a review of our financials.

Kate S. Gulliver

Chief Financial Officer and Chief Administrative Officer, Wayfair, Inc.

Thanks, Niraj, and good morning, everyone. Before I dive into third quarter results, I want to take a moment to emphasize the point that Niraj just made. The key principles of cost efficiency, nailing the basics and earning customer and supplier loyalty have become driving tenets across our organization. In particular, cost efficiency is a mandate to put each dollar of spend under close scrutiny.

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We started by closely examining our operating expenses related to head count across two dimensions: employees and third-party labor like contractors and consultants, with savings that accrue primarily within the SOT G&A line. These programs are already delivering meaningful savings beginning in Q4.

Concurrently, we've been driving a myriad of operational cost savings that will primarily benefit the cost of goods sold line. Several of these initiatives represent areas of cost discipline that were forced to the back burner given the frenzy of the COVID impacted period. Now is the right time to reengage across a series of best practices with savings that will build over 2023.

Combined, we are in motion on a set of actions that represent annualized cost savings of approximately $500 million, of which roughly 60% is related to head count and third-party labor costs, and 40% from operational initiatives. This magnitude is greater than our anticipated adjusted EBITDA losses this year, but we are not finished. In tandem, we are currently actioning on additional savings of several hundred million dollars that we will provide details on during our next call.

Turning now to our third quarter results. As you saw in the press release, Q3 total net revenue was $2.8 billion, a 9% year-over-year decline and a 14% sequential decline from the second quarter. This is largely in line with the quarter-to-date performance that we had previewed in early August. And as we had noted at that time, a weakening macro environment contributed to a break from the typical seasonal pattern in which we would expect revenue to be sequentially flat from the second to the third quarter.

As it has for some time now, net revenue in the US business outperformed the aggregate at a negative 6% year-over-year decline, while our international markets, especially in Europe, continue to be disproportionately impacted by macro headwinds and geopolitical uncertainty. While the operating environment incrementally worsened over the course of Q3, we continue to see customers respond to promotional events in a positive way and are optimistic for what the holiday season will hold this year.

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.

The benefits of CastleGate adoption are most visible on our gross margin line, which climbed nicely again in Q3 to 29.1%. The combination of faster CastleGate penetration and further relief on transportation costs, some of which we have previously absorbed rather than pass on to customers, all helped us to exceed our guided range of 27% to 28%.

Niraj mentioned it briefly earlier, but we're often asked by investors how promotional intensity impacts our margin structure, and the simple answer is not by much. As suppliers on the site choose to lean in with shopper/wholesale, we pass those savings on to the end customer. Our margins stay resilient while also ensuring that our retail prices stay competitive across the landscape.

Advertising as a percentage of net revenue came in at 12.4% for the third quarter, above our guided range. There continue to be various mix effects impacting AC/NR, we went into great detail about the last quarter, and much of what we saw in Q3 reflected similar trends to Q2 where, once again, higher paid versus free traffic is a temporary headwind to this metric. We continue to monitor our paid marketing spend very closely to ensure that we remain within our ROI and payback parameters across each channel.

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Customer service and merchant fees were 5.2% of net revenue, just above our guided range. We saw some inflation in head count across this line item earlier in the quarter. And while we made adjustments to that base subsequently, it still had an impact on the dollar cost for Q3. We expect to see this return closer to historical levels in the fourth quarter.

Finally, our selling, operations, technology and G&A expenses totaled $543 million, just under our guided range. With the reduction towards at the end of August, a small portion of the savings began to accrue over the remainder of the quarter. And as we'll discuss shortly, you should expect to see a more fully realized set of savings in Q4. All combined, our Q3 adjusted EBITDA came in at a negative $124 million or a negative 4% of net revenue, in line with our guided range.

We ended the quarter with $1.3 billion of cash and highly liquid investments. Net cash from operations was a negative $431 million. And capital expenditures totaled $107 million, below our guidance as our cost-cutting initiatives started to play out, leading to free cash flow of negative $538 million for Q3.

As many of you know, we typically enjoy a net working capital benefit when revenue grows sequentially due to the favorable timing differences between receivables and payables, inherent in our business model. However, this dynamic inverts in periods of sequentially declining revenue, like we saw in Q3, resulting in a cash outflow. In fact, more than half of the loss in cash flow from operations this quarter was due to a drag from net working capital.

With Q4 historically representing a sequential up-tick in revenue, we would expect our net working capital to once again positively contribute to cash flow. As many of you saw, in September, we issued $690 million of convertible notes as part of a liquidity management transaction.

We saw an opportunity to use the proceeds to repurchase over $600 million of outstanding convertible notes for a considerable discount, meaningfully reducing our 2024 maturity from $575 million to approximately $200 million, as well as beginning to chip away at our notes due in 2025 and give ourselves even more flexibility as we think about navigating the next few years.

With that, let's now turn to the outlook. Quarter-to-date gross revenue has been trending down in the low single digits year-over-year. Excluding the impact of Way Day 2, gross revenue was down approximately 10% year-over-year. Given the uncertainty around the consumer behavior this holiday season, we would suggest you model year-over-year revenue growth down in the high single-digit range.

Shifting to gross margins, we now believe it is appropriate to move our guidance range up to 28% to 29% for the fourth quarter. Many of the drivers of gross margin outperformance in Q3 are expected to continue. But the typical holiday mix shift will weigh a bit on gross margins in Q4, so we expect to see some pressure sequentially.

As I previewed earlier, we would expect customer service and merchant fees around 5% of net revenue and advertising to be 12% to 13% during Q4, as we continue to see the same set of macro pressures impact the mix of traffic across our channels.

We forecast SOT G&A or OpEx excluding stock-based compensation and related taxes to come in between $495 million and $505 million for the fourth quarter. The full impact from the reduction in force, as well as the third-party labor cuts, are now flowing through. If you follow through the guidance I outlined, that would translate to adjusted EBITDA margins in the negative low single-digit range for the quarter.

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Now let me quickly touch on a few housekeeping items for Q4. Please assume the following: equity-based compensation related taxes of $153 million to $160 million. Depreciation and amortization of approximately $93 million to $98 million; net interest expense of approximately $9 million to $10 million; weighted average shares outstanding equal to approximately 108 million shares; and CapEx in $100 million to $110 million range.

In closing, I would like to reemphasize how unified and focused we are on the three key pillars we've touched on throughout this call. Cost efficiency, nailing the basics and earning customer and supplier loyalty. We have a tight plan to continue to drive cost out of the system in a way that is meaningful and proactive while also allowing for flexibility into the future, a future we see is bright for Wayfair. We're excited for the next 20 years of the laser focus on what needs to be done in 2023 as the first step on that path.

Now Niraj, Steve and I will be happy to take your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Brian Nagel with Oppenheimer.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Hi. Good morning. Thanks for taking my questions. So my first question, again, it's probably more for Kate. You talked a lot about just the advertising expense and the elevated expense we saw here in Q3, and that it sounds like it will persist in Q4. So the question I have is when should that normalize? What will it take for it to normalize? And was that a 20-odd – at some point in 2023?

Then the follow-up question, [indiscernible] (00:23:35). I guess this is more for Niraj. We talked again about CastleGate and the penetration there around 25%. So I guess this is maybe a longer-term strategic question. Where should that number be? Where is that infrastructure, so to say, designed to be? And I guess from a more, touchy feely standpoint, if I'm a customer of yours or a partner of yours now not using CastleGate, why is that? It seems like it's a pretty good offering. Thanks.

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

A

Yeah. Thanks, Brian. This is Niraj. Let me actually jump in and start off on the ad cost question, and then Kate can certainly chime in on that, and then we'll go to your CastleGate question in a second.

I think the main thing, I think, to make sure you understand about that ad cost, the AC/NR percentage number, is there's a set of things that move that number around. And a lot of them have to do with mix.

And one of the things that's happening right now is that if you think about that composition of that number, you have a significant amount of traffic that effectively has zero ad cost. And that's where we have a household brand, we have tens of millions of customers. We have the people downloaded the app. And depending on how top of mind the home category is, they come and they shop Wayfair.

Then we also have what we do in the paid channels. And this is where we manage each channel to a tight payback. We've kept all the channels at payback. So we've not extended any and all the channels are coming in at the payback numbers we want. And there, we're going out and we're targeting and running ads in a way to

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draw people in. Now what happens in times where the category is super top of mind like Q2 of 2020, for example, you're just getting tons of that direct free traffic, and that's going to average this number down.

But in times where, frankly, the category is not on top of mind, which, to be honest, this category, particularly online is not as top of mind right now, things like travel, and leisure, and entertainment and taking share on the discretionary dollar, what happens is just that free traffic is a little less.

Those numbers [indiscernible] (00:25:32) each other, don't need to move very much for the AC/NR percentage to move up or down, even though every channel is a payback. So what I described, that's the single biggest factor that's moving that percentage around right now. And we don't particularly view that as problematic. And the reason we don't view that as problematic is that we've seen the cycle before, and we know where it'll revert to as the environment normalizes.

That said, there's a component of the spend that is in buckets that are either very hard to measure or are high AC/NR or in the experimental phase where they're not at the percentage we want to get them to before, we'll scale them, and we're running different experiments and tests to figure out how to get it there.

And so that bucket is something that frankly, we have been looking at and we're getting a tighter width. And so that will allow us to basically reduce ad cost without really reducing as much revenue because we're taking off the things that are the 'most expensive things' or the least proven things.

And so that's kind of the way to think about it and why the ad cost number maybe is where it is, but also how we can manage it. But Kate, anything do you want to add on that?

Kate S. Gulliver
Chief Financial Officer and Chief Administrative Officer, Wayfair, Inc.
A

Yeah. I think that covers it. I think as Niraj mentioned, obviously, as the mix shifts continue to happen, we may see some of that 12% to 13% as we guided to. But over time, we're obviously managing very closely some of that longer-term payback and bringing that in as necessary.

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

Let me just jump on your second question on CastleGate penetration. Yeah. So as you noted, it's at 25%, which basically means that it's recovering quite nicely from the low [indiscernible] (00:27:05) last year when inventory was super scarce.

And it's on its way to, we think, records and then break those records. It is a great offering. And so we actually have quite a large number of suppliers in it. I think the way to think about it is why would a supplier not be in it. They might not be in it. Either they might be still at a stage where they're just testing it. So they might be in it in a very small way relative to potential.

There are some suppliers who may not be in it yet. And part of that is we obviously focused on having these conversations with our category management team with suppliers who we actively work with. We also have a long tail suppliers who work with us through Partner Home, or Extranet, our systems.

And a lot of the CastleGate self-service functionality is relatively new and we continue to bolster that. So there's a lot of suppliers who get onboarded as it becomes easier to do it in a self-service manner. And then, depending on

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where a supplier's origin points are, there are certain lanes that we have been able to really optimize with the way we do ocean freight and consolidation.

And then there are certain locations we do not yet have the inbound flow set up for, so that just makes it a little harder for a supplier to use CastleGate. They have to handle the inbound flow on their own.

And as you know, this past year and a half has been a really complicated period, because it went from sort of too much demand, too little inventory. So that was sort of – that would work against CastleGate penetration because suppliers couldn't even flow enough goods for the orders they had. Obviously, you saw our penetration numbers get hurt.

So you can imagine new suppliers are not signing up for CastleGate in that period, right? Now you go into a period where there's, effectively excess amounts of inventory. So now you'd have suppliers who are either have been in CastleGate, now there's [indiscernible] (00:28:39) lot more in, I want to drive sales, but you also now have a lot of suppliers say, okay, hey, I now want to figure out how to grow my business in a tough environment. I want to try CastleGate. I want to do things that I wasn't willing to do, weren't willing to do last year, because I just didn't have that need. So I think we're in a phase of more CastleGate adoption, suppliers using it more heavily. We're adding a lot more optimization into it as we're building up the technology around the inbound flows. So, this is all the reasons it will grow.

In terms of what level will it get to, we haven't discussed an exact percentage out there, but what we have talked about is we built a really good logistics footprint. So that phase of opening up buildings just for footprint sake is over. We do have some buildings coming over time that basically help us fill in some gaps in places where we need basically capacity so that we can bring more goods in.

And then, frankly, as the demand environment normalizes, we'll be able to see turns in our network go up, which means that the flow of goods through our buildings, without more buildings will increase just because right now, the way that you see a supplier having an inventory overhang, well, they would have an inventory overhang not just in their own building, but in CastleGate as well because the demand forecast change for everybody. So that's I think the way to think about it. Hopefully, that's helpful.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Well, I appreciate it. Thanks for all the detail.

Operator: Your next question comes from the line of Steven Forbes with Guggenheim Securities.

Steven Forbes
Analyst, Guggenheim Securities LLC

Q

Good morning, Niraj, Steve, Kate. I wanted to start with the outlook for overall logistic cost. So Niraj, curious – or Kate, curious, if you could help frame how you see inbound and outbound? Is it just the cost environment in general as we look out to 2023?

And sort of frame it around what has traditionally been, right, about 20% of overall net sales or the combination of the two. Do you see relief right as we look out over the next 12 to 24 months?

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

A

Yeah. Steven great questions. I would say, if you think about the 20%, we referenced that a number of times in the past. And what that was, was we said, hey, if you took every aspect of the end-to-end logistics, it was round about $0.20 of every revenue dollar.

That was sort of before what happened last year, more than the cost kind of really mushroomed up. So it would have risen – rose significantly from that level. And now if you look at what's happening, things like ocean freight have come back down fairly significantly. And so it's back down to a level that would sort of put you back in that 20%. Some of the things like over-the-road trucking are coming down. They're still somewhat elevated to those aspects, have come down more than other aspects.

But I think broadly, what you should think about is like supply chain costs are reentering that kind of normal historical range, that $0.20. That wasn't true last year. And so it is a deflationary force. And frankly, supply/demand is – right now, there's excess supply relative to demand. That will normalize back out.

So now all of a sudden, all the things we're doing to really add efficiency and elegance around having products travel less miles, by forward positioning them in the right place to begin with, that offers the customer with the speed badge [indiscernible] (00:31:44) delivery.

It offers the customer effectively a lower retail price because the ship costs get factored into the retail, so they see a better price. And we also see less damage. And that is taking share. And so that's a customer value proposition that we are optimizing for that also – it's averaging down that shipping cost over time, which is the reason we've been building up the logistics.

Kate S. Gulliver
Chief Financial Officer and Chief Administrative Officer, Wayfair, Inc.

A

Yeah. Steve, I'd probably just add that as we spoke to on the call, in addition to some of the logistics costs coming in line, we also have taken a series of actions around our operational costs. And that combined is helping us see improvement on that gross margin line, 29% this quarter. And we have confidence in that continuing to grow throughout 2023 due to those combination of actions.

Steven Forbes
Analyst, Guggenheim Securities LLC

Q

Thank you. Maybe just a quick follow-up staying on that same topic. I guess if we think about the impact, right, of lower overall logistic cost and the pass through to consumer. Just help us sort of frame the 2023 outlook for average order value directional-wise. Is it probably fair to say that we should expect average order value to be down, or is it too early to tell given mix changes, potentially, et cetera?

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

A

Yeah, I think there's – a short answer, I think AOV does drop some. The question is like how much. And that's where it gets hard to exactly quantify the how much. But there's definitely some inflation that's already reversed and you're seeing suppliers sort of being proactive around that.

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My cost to bring this item in the future is lower. I have too much right now. Why don't I start pricing it closer to what the future cost can be so that I can move through it faster. So there is relief in the form of reflecting these costs coming down, absolutely.

In terms of how that flows through to revenue, it gets a little tricky because if AOV falls, actually conversion rate and orders pick up. And so you actually don't net lose all of the AOV in a flow through to revenue. So depending on what you're trying to think about the AOV impacting, there's an offset that plays out too.

Steven Forbes
Analyst, Guggenheim Securities LLC

Q

Helpful. Thank you, best of luck.

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

A

Thank you.

Operator: Your next question comes from the line of Jonathan Matuszewski with Jefferies.

Jonathan Matuszewski
Analyst, Jefferies LLC

Q

Just on the $0.5 billion of savings coming out of the business, thanks for the examples you shared regarding returns monetization and other things, how should we think about the impact of those costs coming out to customer experience and potentially customer demand? That's my first question. Thanks.

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

A

Yeah. Great. Jonathan, that's a great question. So just to size this, we did refer to the $500 million of savings. And so if you remember back to the last earnings call in August, we talked about a set of things that we'd already decided to do. That's what the $500 million.

We said we'd provide you detail and quantify it a little later. And so we're now quantifying that. But since that we've expanded the plan, so we've added several hundred million dollars on top of the $500 million. So what you can see is like from a cost standpoint, we decided to be very aggressive around making sure that we're not carrying any excess cost that forces to either drive up retails or not have the profit profile we want to have.

And if you think back to our history for a decade, we operated out of cash flow. We grew the business to $500 million in sales with no outside capital. And we did that by being very lean.

And so when we kind of looked at our cost structure with a fresh set of eyes, there's just a lot of things there that we just saw that, frankly, jeez, while we're just busy managing that dramatic growth from the $9 billion overnight to up over 50% because of COVID, there's a period – extended period of time where maybe not everything was equally focused on as much as it should be. And so the returns monetization is just one example. There's, a number of those areas.

The way to think about what these things do is the impact to customers is effectively, it's either neutral or positive. And why do I say that? Well, either we're taking out cost that's not providing customer benefits, that's neutral if you think about that doesn't hurt the customer, or it's positive if you think about the fact that in some cases, it

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allows you to lower retails or some of the cost optimization we're doing in transportation actually increases speed of delivery.

So, we're like net doing things that are making retails better, making speed better, taking out costs where we think it's adding, not adding to value. So we're not looking at the cost coming on the back of customers. In fact, we're looking at the [indiscernible] (00:36:24) proposition increasing.

And what we're doing is we're sort of streamlining, cleaning up some things that you could argue maybe should have done earlier. Kate, anything do you want to add on the cost?

Kate S. Gulliver
Chief Financial Officer and Chief Administrative Officer, Wayfair, Inc.

A

Yeah, I just want to make sure we clarify. So that 500 million is what we're – what Niraj was sort of just referencing on the gross margin line, about 40% of that $500 million, we think about is operational cost savings and improvements that will flow through in that gross margin. And then, that several hundred million more piece will come back in February with some more details on that for you and provide more context then.

Jonathan Matuszewski
Analyst, Jefferies LLC

Q

That's helpful. Thanks for the clarity there. And then my second question, just on the second Way Day, I think this is the first year you held a second event here. Is this just a reflection of the current inventory environment, or are you kind of changing the philosophy in terms of how you're working with suppliers going forward? Should we expect to see kind of more regular holiday period into perpetuity?

Obviously, you clarified that it doesn't impact kind of gross margin all that much. But just kind of curious what we should expect in terms of promotional holidays going forward as the inventory situation changes. Thanks.

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

A

Yeah, great. Yes, so I think it's important to point out we've always had, along with every other mass retailer, frankly, a pretty solid calendar [indiscernible] (00:37:56). They're around the major shopping holidays, right, President's Day, Labor Day, Memorial Day, Cyber 5.

So we have a calendar through the year, Way Day, Save Big, Give Back, which we redid as 5 Days of Deals this year. And so we have a calendar. The other way to think about it is you can flex it up or down depending on the environment. And so right now, to your point, there's excess inventory and customers are – even though they have plenty of money, they're a little more sitting on the sidelines, and that's kind of a reflection of when we look at the customer sentiment.

And so promotion – what you do in those environments is you flex up the promotional kind of calendar, and it works well. But what you don't do is you don't keep it there forever. So then as the environment normalizes, we bring it back to the normal promotional calendar that we have.

And then there's a period, so they're somewhat rare, but like during COVID, promotions just didn't carry the same bang that they normally do because people are just buying what they wanted every day.

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So there's a little bit of – there's times when it flexes the other way, too, although those are somewhat rare. So just think of it as the bulk of the time you have your normal calendar. That's what you've normally seen us do, which still has a fair amount of sale events in it.

And then during a period like this, there will be a relatively short period of time, but you flex up. And this is – the Way Day 2 is an example of flexing up, but don't think of that like a normal environment thing.

Jonathan Matuszewski
Analyst, Jefferies LLC

Q

Great. Thanks for the color. Best of luck.

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

A

Thank you.

Kate S. Gulliver
Chief Financial Officer and Chief Administrative Officer, Wayfair, Inc.

A

Thank you.

Operator: Your next question comes from the line of Maria Ripps with Canaccord.

Maria Ripps
Analyst, Canaccord Genuity LLC

Q

Great. Thanks so much for taking my questions. Can you just talk about your fulfillment capacity in the US at this point and where you are from the utilization standpoint?

And do you see the possible need to optimize your footprint, sort of in a scenario that revenue continues to be soft in the near term as you focus on cost optimization initiatives, especially as Kate highlighted sort of the next layer of additional savings?

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

A

Yeah. Thanks, Maria. I think the way to think about our footprint is – so we have a good footprint. It's fairly heavily utilized right now, but it's not necessarily at the turns level that we and our suppliers would target.

And that's just a function of this inventory cycle that you're sort of going to be hearing about from everybody everywhere. You've already been hearing about, which is just folks flowed in demand against the demand profile that's since slowed.

They have too much inventory or imbalance on what inventory they have. And they're all now working through it. So if you think of the buildings, it's like two factors, in fact, how much goes through the building. One, of course, is if it's full or not, and the second, what rate does it move in and out. The amount of stuff in the building is quite good. The rate at which it's moving in and out is lower than we would all like. That's why, why do you have a Way Day 2 or why you do these things or why are our suppliers leaning in on price. Well, they want to rightsize their inventory. They want to get back into balance. They want to clear up the excess inventory. They know that giving

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customers' value right now is really the only thing that will kind of dramatically change how share works. So that's happening.

I think when you think about the buildings, I think it's important to realize that the buildings actually reduce our cost versus increase our cost. Because without buildings you can't – when I talk about logistics optimization and taking cost out, the way you do that, the easiest way to think about that is it's just excess miles.

Because if you bring something in, so you bring it into port of L.A., we have 70% of the people in the East Coast of the US and items are sitting in California. Then they got to move really long distance on that final mile leg, which is your most expensive leg to the customer.

Now all of a sudden, you say, hey, I'm going to put some goods off the get-go. I'll put some in Dallas and I'll put some in Jacksonville and some in New Jersey and some in Chicago, et cetera. In relation to what roughly demand balance is, all of a sudden, the customer sees a faster speed, but frankly, our shipping cost goes down dramatically because that inbound leg is not very expensive relative to the outbound leg.

And but obviously, without a building in that place to put the goods in, you can't do what I just said. Our suppliers typically have one warehouse. A small percentage, have two warehouses, and it's a negligible percentage who have more than that. So what happens is, the supplier doesn't have the infrastructure to do this on their own. This is part of why CastleGate is so appealing to them. It's that they then get the benefit of the forward positioning. Their goods get the speed badge, the retails for their goods can drop.

And that it creates – that's a big value proposition for customers, right, and it drives demand to those items. Those items are higher converting to move up in the store. So it's a self-fulfilling positive cycle. And so driving volume through the building is actually a key piece of the strategy to take out cost.

Kate S. Gulliver
Chief Financial Officer and Chief Administrative Officer, Wayfair, Inc.
A

Yeah, I'll just add, Maria, you mentioned how do we think about [indiscernible] (00:42:36) build-out of the FCs in relation to our cost savings initiatives and that core goal for 2023. And as far as the capital expenditures related to the FCs, we're very focused on building that when we need it, not in advance of when we need it. So we intend to be very moderated and thoughtful about any incremental capital expenditure there.

Maria Ripps
Analyst, Canaccord Genuity LLC
Q

Got it. Thank you. That's very helpful. And then secondly, is there anything you're seeing sort of in customer behavior, maybe more recently, that would give you some clues that customer count should return to growth here sometime in the near-term?

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

Yeah, I mean, I think what we're seeing in customer behavior is that customers are responding well and as we would have expected to what we're doing in relation to the macro environment. So if we look at the macro environment and we see customer sentiment low, we see excess goods, we know the playbook for that.

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That's why we have a Way Day 2, et cetera. So we know how to run that playbook. So we run that playbook of these exciting events. We're seeing suppliers participate in great way and we know how to market those out to customers and we're seeing that they respond.

So they're coming in, they're buying. We're seeing that work incredibly well. And as you're seeing, gross margin is holding up. So what we're not doing is we're not doing it by discount and what we're doing is we're investing in running that playbook.

Suppliers understand how to use that playbook. Customers respond well to that playbook. It's a perfect playbook for this environment. And it's working really well. And that's kind of why we also gave you some feel on the impact of Way Day, when we talked about the revenue levels.

And I think that this environment is going to be here for a little while, right. It's not something that's going to go away. And the amount of excess inventory is going to also take a little bit of time to work through. So this is – and you can think about this environment lasting, I would probably say a small number of quarters. But it's not weeks or shorter months.

Kate S. Gulliver
Chief Financial Officer and Chief Administrative Officer, Wayfair, Inc.
A

Yeah, but long-term, our view of the potential, the total TAM, our position in that, where e-comm penetration should land, that has not changed. So while there may be some volatility in the near term, our long-term outlook has not moved.

Maria Ripps
Analyst, Canaccord Genuity LLC
Q

Great. Thank you so much for the color.

Operator: Your next question comes from the line of Greg Melich with Evercore ISI. Greg, your line is open. The question has been withdrawn. Your next question comes from the line of Alexandra Steiger with Goldman Sachs.

Alexandra Steiger
Analyst, Goldman Sachs Bank Europe SE (Germany)
Q

Thank you so much for taking my question. I wanted to follow-up on the active customer growth question here. Given the scale and reach you achieved during the pandemic, how do you think about the potential of customer reactivation to support forward growth? And how large do you see reactivation as an opportunity relative to new customer growth going forward? Thank you so much.

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

Yeah. Thanks Alexandra. Yeah, I think reactivation of people [indiscernible] (00:45:43) actually, frankly, a big opportunity, right? And so if you think about it, we have, over time, built a large kind of following amongst customers, a number of which have a [indiscernible] (00:45:59), a number of which are on our e-mail list, a number of which visit regularly.

Right now you have a macro phenomenon where basically customer – this category is just not the top of mind thing. And there's swings that happen. And they revert to the mean over time. We are doing a lot to make sure

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that we are positioning as the go-to home retailer, the largest specialist in home, that we are getting those customers coming back to us as the category becomes back more further top of mind.

And then there are specific things on the marketing side we're doing to help drive that as well. And we have the benefit because a lot of what's happened on the ad landscape out there is it makes it very hard for someone who doesn't already have that customer file to effectively market at a reasonable cost.

What we have because of the first-party data and the direct reach, is we have the ability to reach directly to these customers. And that's a very major benefit. Only the largest companies have that benefit today because of what's changed in the privacy landscape and then with some of the technologies I'm targeting out there. And so reactivating customers that have not purchased in the recent past, we view this as a huge opportunity. There's a lot of things we're working on along those lines.

Operator: Your next question comes from the line of Anna Andreeva with Needham.

Anna Andreeva
Analyst, Needham & Co. LLC

Q

Great. Thank you so much and good morning. Thank you, guys for all the color. Very helpful. Two questions from us. You mentioned that environment got worse as the third quarter progressed, but consumer obviously continues to respond. I'm not sure if I missed this, but what was the monthly cadence during the third quarter?

And then secondly, could you talk a bit more about international continues to be a pretty meaningful drag on the business, obviously, macro is difficult. Do you think getting closer to breakeven is realistic for 2023 in international bucket? And what are some of the expense opportunities in the business that you could implement to get there? Thank you so much.

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

A

Yeah, great. Let me start to answer some of your questions. I'll ask Kate to jump in too. On the environment getting worse in Q3, I'm not sure exactly what the comment we made was referring to that.

Kate S. Gulliver
Chief Financial Officer and Chief Administrative Officer, Wayfair, Inc.

A

Yeah. Hey, we don't typically disclose monthly trends. Certainly, I think all that we've said and what I would reiterate is that we do see the customer coming in during promotional activities right now. And those tend to be highlights for us at this moment. And the broader macro context, obviously, is a little bit uncertain right now.

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

A

But I would say, like, I don't think the environment is worsening. I think it's more like been steady. It's not improving. It's like steady as maybe the way I would phrase it to give you the context of what I'm seeing.

On the international, there's no question that out of the four countries – that we operate in five countries today, and technically we have four major ones in terms of UK, Germany, Canada and the United States. The United States economically is holding up the best of those four.

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And that's effectively a macro, you see that in the macro data. And then, of course, we see it in our micro data. Now, every country has a different set of issues it's working through. And in all of them, we believe that online sales of home goods is below the normal trend that we'll revert to.

But as we mentioned, the timing of how exactly that curve plays out is very hard to estimate. So what are we doing? There's a big focus on micro tailwinds that we can drive share up. And we're executing on those.

And we're actually seeing those working. Then to your question on cost, we've also – we talked about the $500 million and then we talked about the [several hundred million] more on top of the $500 million. We're taking out a tremendous amount of cost, which we think positions us incredibly well.

So if you think about the netting, like if you're getting tighter on cost, a lot of that's driving down retail as well. And then at the same time, you think that there's micro tailwinds where you can take share based on things you're doing.

Now, of course, you have the macro, which is cloudy for a period of time, but the netting of all that, we think, is quite a positive story. And so we think that will play out quite well. In terms of how to think about international, I think really at the country level, every country is working through a different set of things.

And obviously, the countries we're smaller in, so I think the opportunity for the tailwinds to be faster there is higher when we have a smaller share. But honestly, the macro conditions in these countries are quite different, and some of them are quite challenging right now.

Kate S. Gulliver
Chief Financial Officer and Chief Administrative Officer, Wayfair, Inc.
A

And as we said, we intend to get to EBITDA profitability regardless of the top line. That's in aggregate. We're very focused on that goal. We see no structural reason why the international sector over time can't perform as well as the US sector.

And certainly, when we talk about that $500 million in cost savings and that several hundred million more, that's across our entire business, that's not focused on one geography.

Anna Andreeva
Analyst, Needham & Co. LLC
Q

Great. That's helpful guys. Thanks so much.

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

Thank you.

Operator: We will take one more question. And your final question comes from the line of John Blackledge with Cowen.

John Blackledge
Analyst, Cowen & Co. LLC
Q

Hi. Great. Thanks. Two questions. First on the competitive positioning, I think Wayfair's US revenue is down kind of like high single digits through the third quarter. How do you think Wayfair is doing relative to the US home

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market through the third quarter? Do you think Wayfair's competitive positioning has changed at all versus pre-pandemic?

And then just second question, in the past, you said returning customers typically cost 4% to 7% added expense as a percent of revenue. Does that still hold? Or just given the macro environment, is it more expensive to get a returning customer? Thank you.

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

A

Yeah. Thanks. So on the first part of your question, competitive positioning in the US, so I think the US was down, I think, 6%. And I think what we're seeing in the US is that our competitive positioning, super high level of competitive positioning is the same as it's been. Our competitors are the same set of competitors.

There's a long tail of competitors. So we have a few sort of large competitors and then a long tail of folks in the category. I do think – when we talk about the micro tailwinds though; I do think there are some things that through the cycle of COVID kind of hurt us. And so as I've tried to talk about kind of the big three sometimes, but they're basically product availability got pretty bad for a period of time, the speed positioning. So the forward position of these goods got quite bad.

And then the retails got quite bad of the combination of how inflation was passed through and the lack of forward positioning. So if you think about that that kind of erodes an offer. Well, where are we now? We're now reasonably forward into a cycle which is reversing those things.

So speed is – we've gotten to all-time highs on speed, and that's continuing to climb at a fast rate, availability has recovered quite nicely, and that actually has still some nice headroom ahead of it, that we have very good insight into, and retail prices have been falling quite nicely.

And like if you look on our side, you look at what we're offering right now for holiday and you compare it to others, I think you'd be like, yes, wow, it feels quite good. So there's, sort of these things that are playing out quite well.

So we feel very good about our position both as a home retailer and the bespoke things we're doing, and then specifically on these core elements of the offer and particularly where we are relative to where we were a year ago due to the kind of these external forces that were far out of our control.

Now, on the economics of returning customers, returning customers are definitely show you a lot of leverage. In fact, the way it works is the cost to go from one order to two orders is obviously well, and that's kind of where I think we said.

We talked about repeat on average being 7%. The way I think about it is like one to two is the number percentage and then that percentage drops when you go from the second and the third order and then that percentage drops again when you go from the third to the fourth order.

So as someone kind of thinking of this like this loyalty ladder, they climb up the ladder, they get increasingly less expensive from an ad cost standpoint for that next order. I think the thing that's complicating the ad cost outlook right now that makes it murky is the thing I tried to talk about earlier, this free channel paid channel mix shift which is effectively a byproduct to the macro environment, and you will – just like you've seen it go one way you'll see it reverse back.

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But I think that's what makes it harder for you to see the ad economics underneath. And so I'd just remind you of that because that I think is kind of the thing that's causing it to not be as clear.

John Blackledge
Analyst, Cowen & Co. LLC

Q

Thank you.

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

Okay, great. Well, I think with that, I think we're wrapping up the call. So I want to thank everybody for joining us this morning. And I hope you all have a great holiday season.

Kate S. Gulliver
Chief Financial Officer and Chief Administrative Officer, Wayfair, Inc.

Thank you all.

Operator: This concludes today's conference. You may disconnect at this time.

***Editor's Note: Texts in brackets were added at the request of the company for clarification.

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