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Wayfair, Inc. (W)

Q4 2022 Earnings Call

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CORPORATE PARTICIPANTS

James Lamb
Head-Investor Relations, Wayfair, Inc.

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

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

Steven K. Conine
Co-Chairman and Co-Founder, Wayfair, Inc.

OTHER PARTICIPANTS

Christopher Horvers
Analyst, JPMorgan Securities LLC

Curtis Nagle
Analyst, BofA Securities, Inc.

Ygal Arounian
Analyst, Citigroup Global Markets, Inc.

Atul Maheswari
Analyst, UBS Securities LLC

Seth Basham
Analyst, Wedbush Securities, Inc.

Steven Forbes
Analyst, Guggenheim Securities LLC

Anna Andreeva
Analyst, Needham & Co. LLC

John Blackledge
Analyst, Cowen and Company

MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to Wayfair's Fourth Quarter 2022 Earnings Conference Call. All participants are in a listen-only mode. After the speakers' presentation, we will conduct a question-and-answer session. [Operator Instructions] As a reminder, this conference call is being recorded.

I would now like to turn the call over to James Lamb, Head of Investor Relations. Thank you. Please go ahead, sir.

James Lamb

Head-Investor Relations, Wayfair, Inc.

Good morning and thank you for joining us. Today, we will review our fourth 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 our call today will consist of forward-looking statements, including, but not limited to, those regarding our future prospects, business strategies, industry trends, and our financial performance, including guidance for the first quarter of 2023.

All forward-looking statements made on today's call are based on information available to us as of today's date. We cannot guarantee that any forward-looking statements will be accurate, although we believe that we have been reasonable in our expectations and assumptions.

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Our 10-K for 2022 and our subsequent SEC filings identify certain factors that could cause the company's actual results to differ materially from those projected in any forward-looking statements made today. Except as required by law, we undertake no obligation to publicly update or revise any of these statements whether as a result of any new information, future events or otherwise.

Also, please note that during this call, we will discuss certain non-GAAP financial measures as we review the company's performance, including adjusted EBITDA, 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. It's great to reconnect with you today to share the details of Wayfair's fourth quarter 2022 results. 2022 was a challenging year for our entire industry in more ways than one.

As an ambitious technology-driven company, it is a challenge to manage all facets of growth in normal times, never mind unusual ones. One of the most important things we can do to be successful is to rapidly acknowledge when the facts on the ground change in real-time and make the appropriate adjustments to business plans in response.

You've seen us do this several times over the past year with our cost-efficiency initiatives and we feel confident that when we look back several years from now, we will view these pivots as difficult, but both necessary and wise. This morning, we published our latest shareholder letter, which I would encourage you all to read on our Investor Relations site.

Steve and I walked through the evolution of our business over the past three years, explaining the ups and downs that the pandemic and its after effects have brought to our category and to Wayfair. We conclude with a look at the future and do so through the lens of our view around capital allocation. We hope you'll find it illuminating, especially in light of the current macro environment.

Our core focus is a return to our history as a company that operates in a lean and efficient manner. We note in the letter that scarcity is actually a good thing for Wayfair. Scarcity of resources drives faster alignment, more productivity and better execution, and we are beginning to see the payoff from those efforts in our Q4 results today.

We reported $3.1 billion of net revenue and 11 million orders in the fourth quarter. While we always expect a sequential revenue increase in the holiday quarter, looking at sequential order volume tells the full story. Our more than 25% order growth compared to Q3 is a testament to the improvements we continue to make in every part of our flywheel, which facilitates our future momentum.

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We had a good holiday season with gross revenue over Cyber 5 matching what we did last year. Over the Thanksgiving weekend, we sold a mattress every 9.2 seconds. So many that if we stack them all end-to-end, it would reach nearly 12 miles high. Our success at the end of the year is a strong proof point that there are three major principles behind our current strategy: one, driving cost efficiency; two, nailing the basics; and three, earning customer and supplier loyalty are bearing fruit in the form of share capture.

To start, let's dive deeper on how we are driving cost efficiency and the latest developments there. Our journey on the path to cost efficiency started last spring as we swiftly reacted to a changing macro environment and put a hiring freeze in place. It became clear that 2022 was diverging from our original set of expectations. And in August, we made a difficult decision to part ways with nearly 10% of our corporate employee population.

As we then looked at our company priorities, team composition and the cost structure in aggregate, we ultimately move fast on a comprehensive plan covering $1.4 billion of cost actions across the entire business. Our execution on this set of initiatives led to the hard but necessary decision to eliminate 1,750 additional roles, including approximately 1,200 roles or 18% of our corporate employees across the organization last month.

It's easy to get wrapped up in the financial implications of a reduction in head count and detach from the human element. So before I discuss the savings, let me say this. Steve and I are immensely grateful to have such a talented and enthusiastic team that we work with every day. Across all of our stakeholders, our employees are the most important because without them, we cannot effectively serve any of our other partners. We want to take the opportunity once more to say to all current and former Wayfair team members, thank you.

In total, our labor reductions have driven over $750 million of annualized cost savings from when we started this effort in the second quarter of 2022. On top of that, we've made considerable progress across operational cost-savings initiatives, which we anticipate will total more than $500 million of annualized savings once fully realized later this year. We discussed these initiatives a bit last November, where I highlighted returns monetization as one of the many areas, in which we're looking to drive more efficiency.

While the savings all accrued to our cost of goods sold line, these initiatives stretch across all areas of the organization. For example, we've kicked off a promising supplier transfer program or in select cases we choose to pass on customer calls to suppliers to utilize their strong domain expertise to diagnose and resolve customer issues directly.

Suppliers can usually identify the ideal resolution. For example, sending a specific replacement part rather than needing a full replacement, more quickly than one of our service representatives, resulting in a more efficient and less costly resolution for the customer and for Wayfair.

Yet another initiative is leveraging our enormous database of orders to understand the relative rate of damage and other incident risk for items based on delivery location and to factor that into the amount of exposure that items receive on our platform, lowering cost and also improving the customer experience.

The final piece of our $1.4 billion of global cost actions comes from over $150 million of annualized savings against our previously planned spend. We put every element of our 2023 spending plans under the microscope in order to think more deliberately about the value we were modeling for each new dollar spent and what we expect will continue to be a challenging customer environment.

The combined result is a significant reduction across many of our remaining large cost areas, most notably advertising, capital expenditures and various G&A expenses. To offer an example in the advertising realm, we

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typically designate portions of our marketing spend that are used for testing and iterating across new channels. This is an important part of our process to find the new breakthroughs that allow us to then scale up these new ad channels at positive ROI and the ever-evolving digital advertising landscape.

However, over time, some of these test budgets have grown to a level that was disproportionately large relative to the goal of being modest test budgets. This type of prudent approach applied to all cost lines and added up to large savings.

One of the most important points that I want to ensure is not missed is that across everything we are doing to drive cost efficiency in the organization, we are not sacrificing our large growth opportunities, and we're doing this while we are also lowering retail prices.

We remain as excited as ever for all of the major initiatives that we are working towards including Wayfair Professional, our specialty retail brands, our luxury platform Perigold, catalog expansion efforts, physical retail stores and international markets, and how a return to our core operating philosophy will enable us to unlock these new growth vectors going forward.

As confident as we are in the steps we have taken to get back to our roots, it's important to remember that the macro environment is still very uncertain. Consumer sentiment remains under pressure given the uneven state of the economy with multiple cross-currents impacting the directions of interest rates, housing data and the mix of wallet share to services over goods.

In spite of all the noise, we remain empowered by the elements of Wayfair that make us a unique and premier shopping destination for home, and as a result, the strength of our market share trajectory.

Exiting 2022, we believe that we have now regained all of the share loss we experienced during the second half of 2021, driven by a myriad of factors related to our core recipe. The shareholder letter also explores this topic in more detail, but let me reiterate our belief that the key elements of availability, speed and price are responsible for our improving market share position.

Coming back to our three key principles. I already touched on cost efficiency, and Kate will provide additional details on the numbers a little later. Now let's revisit the concept of nailing the basics.

Inventory availability is just one example of how our offering has improved, particularly year-over-year. Exiting 2022, availability hit the highest point since the beginning of the pandemic, setting the stage to propel the rest of the flywheel. While this was primarily due to the easing of supply-chain congestion and a demand slowdown in the spring of 2022, we have also driven this improvement across multiple dimensions, including executing more efficient induction of goods directly from Asia and offering improved inventory visibility within CastleGate, so suppliers can more easily track their products.

To complement our in-stock position on goods, we've achieved stronger results on our speed metrics. In fact, over the course of 2022, we shaved a full day of our average delivery speed. Tighter integration with carriers has enabled this acceleration while also helping diminish fulfillment costs. Along with other factors, the combination of better availability and faster speed helps to drive a better experience for our consumers on an everyday basis.

Perigold is another area to highlight under nail the basics as we continue to build the brand's assortment and customer reach with approximately 30% of Perigold customers new to Wayfair. We're also proud of our satisfaction scores for the brand, best measured by Net Promoter Score now at all-time highs. Taking a higher-

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level view, the steady traction we have been building in this brand since its launch in late 2017 through today, is a testament to our ability to effectively deploy capital back into our business.

We test, iterate and develop our Wayfair family of brands in ways to expand our opportunities, while also making sure that we drive a healthy ROI. In fact, part of Perigold's success has been a growing presence within our Wayfair Professional business, which leads to our third key principle, earning customer and supplier loyalty every day.

The business-to-business opportunity is a meaningful piece of the overall TAM in our category, estimated to be nearly a couple of hundred billion dollars between North America and Western Europe. The differentiators of Wayfair's business to consumer platform give us unique advantages in our approach to the professional business and our ability to drive value for both customers and suppliers.

Wayfair serves a wide array of customers on the professional side, ranging from interior designers to contractors, restaurants, to offices, to hospitality. We are focused on illustrating the full-value proposition we can provide, supporting the very first steps of a project through our specialized designers, as we partnered a concept how to space, all the way to ensuring everything ordered arrives on site at the same time through our consolidated delivery.

We're also utilizing our data science models to target leads more effectively with visible traction on prospect activations and other metrics. The result of these advances is a business that saw a strong year-over-year growth in 2022 as customers increasingly rely on Wayfair Professional for the rate combination of products and service.

While a small base of shoppers, we saw the number of customers that spend more than $20,000 per year grow by 20% in 2022 as compared to 2021. Our success within Professional is a microcosm of our mission to drive customer and supplier loyalty with opportunities for further progress across the broad Wayfair ecosystem.

I want to wrap up by returning to where we started. The difficulties we faced in 2022 catalyzed several meaningful changes for Wayfair, enabling us to enter this New Year as a lean execution-focused organization. 2023 will be a year of rigorous execution on the key priorities for the company, where we intend to build on the recent momentum highlighted in our Cyber 5 and January press releases.

Although, the short-term macroeconomic picture is unpredictable, we are optimistic in our ability to navigate the challenges based on a return to form in the core recipe and the flexibility of our business model compared to peers. And regardless of what happens on the top line, we are reaffirming our commitment to reaching adjusted EBITDA profitability soon.

From there, our focus is on consistently generating and ultimately scaling positive free cash flow. Importantly, we consider these goals in the context of total shares outstanding with an emphasis on maximizing profitability and minimizing dilution.

Thank you, and I'll now hand 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 we take a look at our fourth quarter results, I want to take a moment to echo something Niraj said. We are tremendously grateful that so many talented and driven individuals

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share our vision for creating the world's best place to shop for their home. And so to everyone on the team, I want to say thank you as well.

Now, let's dive into the fourth quarter results. After which, I'll walk through the cost-savings measures that Niraj discussed earlier in more financial detail before wrapping up with guidance and closing remarks.

Net revenue for the fourth quarter of 2022 was $3.1 billion, down 5% year-over-year, but up 9% sequentially from the third quarter. This was slightly better than we had anticipated when we spoke last November, and earlier, Niraj highlighted the strength in order volume we saw with 11 million orders, up more than 25% from Q3 more than offsetting a decline in AOV of 13% from last quarter.

We're very excited to see inflationary pressures reverting and order volume reacting positively as expected. Customers continue to show strong response to promotions and we had a robust holiday calendar, starting with our second Way Day in October going all the way through the New Year.

The fourth quarter saw the trends between our US and international segments stay largely consistent with what we observed during Q3, which was an improvement in comparison to the first half of the year. Net revenue in the US outperformed the aggregate and was only down 2% compared to Q4 of 2021, while international was down 20% against last year as the macro pressure continues to weigh more heavily outside of the United States.

I'll now move further down the P&L. As I do, please note that the remaining financials include depreciation, amortization, but exclude equity-based compensation, related taxes, and other adjustments. I will use the same basis when discussing our outlook as well.

We saw another strong quarter on the gross profit line with gross margins of 28.9%, coming in at the high end of our guided range. The drivers here remain largely unchanged from last quarter with more favorability in the transportation environment and strong levels of CastleGate penetration working to our advantage. In fact, we ended 2022 with considerably more suppliers leveraging CastleGate than we had at the end of 2021.

As we saw for several quarters this year, our strength on the gross margin line persisted even in the presence of a considerably more promotional environment as suppliers continue to work through inventory stockpiles.

Customer service and merchant fees were 5% of net revenue. Advertising came in at 13.1% of net revenue. As we've discussed at length in prior calls, the advertising margin continues to be pressured by lower free and direct traffic. While this will recover as a function of the macro, we remain steadfast behind the efficiency targets that drive every dollar that we spent here.

Finally, our selling, operations, technology, general, and administrative expenses totaled $508 million. You are now seeing the full impact of the cost-efficiency action we took in the second half of 2022 manifest. And as you know well, there is considerably more that we've done since.

All combined, our Q4 adjusted EBITDA came in at negative $71 million or negative 2.3% of net revenue. You've heard us talk at length about the path to profitability as we look to get back to positive adjusted EBITDA and ultimately, free cash flow. And so, it's worth calling out that we showed positive adjusted EBITDA in our US segment of $11 million for the fourth quarter. We ended the year with $1.3 billion of cash and highly liquid investments on our balance sheet and $1.8 billion of total liquidity, including our revolving credit facility.

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Net cash from operations was a positive $98 million, while capital expenditures were $117 million, resulting in free cash flow during the quarter of negative $19 million. During our third quarter call, we had discussed how the working capital dynamics of our business would lead to a cash inflow during the quarter with sequential revenue growth, and we saw that play out in our net working capital line items during Q4.

Now before I turn to guidance, I want to spend a moment walking through some of the cost-savings initiatives that we announced last month and what you can expect from a financial perspective. Starting with the labor savings, we have now taken action to drive approximately $750 million of annualized total savings compared to our baseline period of Q2 last year. $450 million of this came as a function of the workforce reduction in January.

While the majority of those cost benefits will occur in Q1 of 2023, you'll see this fully manifest on the P&L by the second quarter of 2023. Across that annualized $450 million bucket, about $290 million is related to cash compensation that impacts the customer service line and our SOT G&A line compared to where we ended 2022. The remainder are reductions to steady-state equity-based compensation.

Turning to the operational cost efforts. As we've mentioned several times, these savings will ultimately come in the form of reductions to our cost of goods sold line. Last quarter, we talked about $200 million of annualized opportunity here, but previewed that there were several hundred million more in total savings that we are working toward on top of that.

As part of the announcement in January, you saw that we have now grown that figure to $500 million of annualized savings here, all as part of the initiatives that Niraj touched on earlier. While these savings will build over the course of 2023, we intend to reinvest a healthy portion back into the customer experience in the form of merchandising investments.

The exact mix will be a function of the macro environment that we see play out over the course of the year. The end result of all the actions we've taken so far is to pull up our timetable in reaching adjusted EBITDA breakeven as the first step on the path toward a self-funded state. You can see this path clearly laid out as part of a new slide in our refreshed investor presentation.

As we started to map out this journey last August, we said that we'd be profitable by Q4 of 2023 at the latest. With the actions we've taken this past January, we feel confident we'll reach this goal earlier than originally planned. And while we believe we have taken the necessary steps to deliver on this commitment, we are prepared to take additional actions depending on the state of the macro environment.

Now, let's turn to guidance for the first quarter. Quarter-to-date gross revenue has been trending down about 10% year-over-year. However, we are seeing a return to traditional seasonality in the core business, and we expect net revenue to end the quarter down in the high-single digits.

On gross margins, we continue to guide you to the 28% to 29% range that we used for Q4. We expect customer service and merchant fees to be around 5% of net revenue and advertising to be 12% to 13% for the first quarter. This guidance mirrors what we said in Q4 as we largely see the same drivers impacting these lines right now.

We forecast SOT G&A or OpEx, excluding equity-based compensation, related taxes and restructuring charges, to come in between $475 million and $485 million for the first quarter. You're seeing the majority of the labor cost savings flow during Q1 and the entire value will manifest in the Q2 SOT G&A figure.

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If you follow through the guidance I've just outlined, that should translate to adjusted EBITDA margins in the negative low single-digits for the first quarter. While we don't guide on free cash flow, I thought it would be helpful to offer a reminder around the working capital dynamics for our business.

Our negative cash conversion cycle means that in quarters where revenue grows sequentially, working capital proved to be a source of cash and vice versa were revenue declines from the period prior. As with normal seasonality, this Q1 is poised to be down sequentially from Q4, so we would expect working capital to be an outflow this period.

As many of you know, the seasonality of our business typically shows sequential growth starting in Q2. So, we would expect working capital to become a source of cash as we get further into the year.

Now, let me touch on a few housekeeping items for Q1. Please assume the following: equity-based compensation related taxes of $145 million to $155 million, depreciation and amortization of approximately $102 million to $107 million, net interest expense of approximately $4 million, weighted average shares outstanding equal to approximately 111 million and CapEx in a $90 million to $100 million range.

As I wrap up, I wanted to take a moment to highlight something Niraj and Steve included in their shareholder letter. Investors often ask us about our views on return on investment, especially in an environment where capital is much less readily available than it was just a few years ago.

To sum up our response, a core part of our organizational DNA is taking a deliberate considered approach to every dollar we spend across the company. And you see this manifest in the improvement to unit economics that we've seen over the past several years.

We have confidence in our ability to reach breakeven adjusted EBITDA margins to aggressively ramp to a mid-single-digit adjusted EBITDA range which we view as a philosophical floor and then continue to our target beyond 10% because of this very DNA and the team operating behind it. Above all, we are measuring our success by growing free cash flow, while at the same time, limiting and ultimately offsetting dilution.

Thank you. And now Niraj, Steve and I will take your questions.

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QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from Christopher Horvers from JPM. Please go ahead, your line is open.

Christopher Horvers
Analyst, JPMorgan Securities LLC

Q

Thanks. Good morning. So, my first question is on the top line. So, you're in an advantaged situation right now with better in stocks than you had a year ago as the supply chain loosened up. Can you talk about when you start to anniversary that? And then bigger picture, guide the year on sales. But how are you looking at it? Are you looking at historical seasonality and thinking about how you project beyond the first quarter?

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

A

Yeah. Chris, thanks for the question. This is Niraj. So, a couple of thoughts on that. So, first, we are seeing the traditional seasonal cadence playing out so far, not just the start of this year, but sort of the shape of Q4 into Q1. And so in that sense, we do feel like there is a trend there. But to take a step back to answer your question, where you started about the top line relative to availability getting better.

Remember the time line on that. So availability got poor, starting in 2021 based on the production shutdowns and the supply chain congestion, et cetera. It's got better starting in the spring of 2022. So spring of 2022, availability gets good. And in fact, supply chain eases up to all, some suppliers have ample availability.

Then in the summer, basically the speed of delivery gets better and that's because suppliers are now for positioning goods to maximize sales. And then by the time you get to the fall, our retail prices, get good again because the inflation that we particularly got hit with, because we don't buy inventory in advance, has sort of abated, been pulled back out.

So then when you look at this year, when you think about the comps, if you're doing it year-over-year, right now, we're in a period where last year, we had elevated demand. The first part of the year had elevated demand. This was the time of Omicron last year, et cetera, and so we're comping against that.

And now, we're – kind of the first half of last year, kind of, now through the spring, you see that elevated demand come out of the market then you see it sort of be normal in the second half. So, the comps in the first half sort of have us comping off an increasingly less high-demand environment, but still a high-demand environment. Then you get a normal sort of demand environment in the second half.

The way we look at it is, we sort of don't particularly start by looking at it year-over-year. We look at it seasonally, and that's why kind of what's the shape of Q4 into Q2, what's the shape of December into January, January into February, the outdoor season is something that is meaningful for us, that starts shortly. And what we're seeing is we're seeing demand holding up quite nicely compared to that seasonal pattern.

And so this is what we thought and what we saw last year. However, last year then, as I mentioned, in the spring, demand macro weakened that we didn't foresee. I don't think anyone foresaw. However, in our case, we were able to use that to get the recipe back intact, which is why we started taking share starting in the fourth quarter.

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Ever since then, we're seeing a nice tight kind of seasonal pattern holding. And so there's a wide range of outcomes if that seasonal pattern holds. We're pretty excited about that. That is, kind of, what we're seeing right now. But on the profitability point, we feel like we can achieve the profitability in a range of outcomes. So we're pretty happy about that as well.

Christopher Horvers
Analyst, JPMorgan Securities LLC

Q

Got it. That's very helpful. And then just one follow-up on the SOT G&A side. You talked about $475 million to $485 million, but you get the full run rate in the second quarter. How much is left? And sort of how do you think about the run rate beyond the first quarter? Thank you.

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

A

Yeah. Let me – Kate, you want to fill that?

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

A

Yeah. Hi. Good morning, Chris. So, I think it's important to remember that that savings that we're talking about seeing on the SOT G&A line, we also expect to see some of that flow through the customer service and merchant fee lines. We took head count out of both of those cost buckets. And you should see the majority of that actually flow through in Q1.

As a reminder, Jan 20 was the date of our [indiscernible] (00:30:30). So think about a little more than two-thirds of that, 70% of that, to be – remainder of that quarter or this quarter didn't have the cost of those folks in it. So you'll see the entirety in Q2, but the majority of it will already be hitting in Q1 is in that guide.

The other thing I would note is that when you look at SOT G&A, about half of that is related to compensation costs, what we're talking about here. The remainder are things like software costs and T&E. And there are some other puts and takes there that you could see in the other cost buckets on that line item as you look at Q1 and Q2.

Christopher Horvers
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you.

Operator: Our next question comes from Curtis Nagle from Bank of America. Please go ahead. Your line is open.

Curtis Nagle
Analyst, BofA Securities, Inc.

Q

Great. Thanks very much for taking the questions. Just wanted to quickly focus on the COGS line. So, that will take just a little bit longer to flow through because it's operational stuff. Just – one, I just wanted to make sure I heard this correctly that the $500 million gross cuts will be realized by the end of the year?

And I guess, number two, could you give a little more detail in terms of the extent of the reinvestment? And I'll let's just say things from a macro perspective, kind of stay where they are, would that equate to something like 50% reinvestment? Or what's the framework there?

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

A

Sure. Let me start – thanks for the question. Let me start with some thoughts and then let me let Kate answer and share some more thoughts as well. I think the way to think about it is there's a lot of operational cost savings that we've identified that are very tangible and there are projects that are underway and they generally are taking out waste that basically does not impede the experience of suppliers or customers and so that's the big benefit.

And basically, to your point, you pass it through manifest as lower retail prices. And if you keep it, manifests us profit and the quantum, as we've said, over $500 million is the quantum we've sized, it's meaningful, and so we're very excited about that.

We've not made a predetermined decision on how the split will be. And in fact, that is one of the many levers we use to manage the business. And so, we're executing on that. The movement of unearthing those costs is moving very well. But in terms of how exactly we let it play through, there's not an answer. I think that's fixed. But Kate, I don't know if there's anything you want to share?

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

A

Yes, I think that's fair. And I guess I would add a few points. So, we've seen gross margin improve nicely throughout the course of the past year. We do expect to continue to build on some of those gains. But we want to hold this back as an operating lever for us. And I think it gives us actually a fair amount of dexterity in this environment, which is an advantage.

And so, we will make this decision, sort of, iteratively throughout the year. And as we see an opportunity to invest in the customer experience, we can use it that way as we see an opportunity to flow through, we can use it that way. But irrespective of that, you've seen nice improvement in gross margin in 2022 and should expect to see some of that in 2023 as well.

Operator: Our next question comes from Ygal Arounian from Citigroup. Please go ahead, your line is open.

Ygal Arounian
Analyst, Citigroup Global Markets, Inc.

Q

Hey good morning. I want to dive into the macro a little bit more. Just maybe we could expand a little bit more on the US versus Europe trends. I understood that Europe has more challenges right now. But how can we read through some of the positive factors we're seeing in the US?

And then how could we translate that forward? We've talked about promotional activity over the holidays. Is that – as we're going through in the early part of this year, is that continuing to be a big factor and how are we thinking about that?

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

A

Sure. Let me field that and I don't know if Kate or Steve want to chime in. But first thought I had on the macro, the international segment in the way we report is everything outside the United States. So, that also includes Canada. But I would say Canada is in the same situation as the UK and Germany, where the macro is significantly more difficult and challenged than in the United States. And in addition to that, the comp, so the elevated demand was

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heightened in those countries in the first half of last year relative to how the US was heightened. So, they're all heightened, but to different degrees.

So, there's a normalization period that you need to go through before you get to normalized comps in the back half, where the shape of the curve looks a little different in those different countries for the first half of the year. So, I think it's important to kind of highlight that.

The next thing is on the inflation, the inflation that came into good, some was raw materials, some was labor. A lot of it was ocean freight. And then what's happened is, it's pretty clear that ocean freight has substantially reversed. So when folks think about replenishment costs, it's significantly lower for suppliers than the cost basis that they brought goods in at last year.

What's happened is in the US, folks look at replenishment cost, it's substantially lower. They're dropping wholesales to basically work towards that number. So in fact, the shape over time is you're going to see suppliers in the US keep dropping prices until they get to that replenishment cost with the margin they want. So the US trajectory for prices is not discounting where it needs to go up at some point, is actually following the shape of the curve down, they're still down to go.

In Canada, the UK and Germany, the storyline is a little different where the cost of energy and then the FX cost, the foreign exchange costs because goods coming out of Asia are denominated in the US dollar. Those things have eroded a lot of the ocean freight savings. So on imported goods, there's less savings on replenishment costs than there is in the US. And so there, you're seeing the curve on costing coming down also being slower. So that combination of those dynamics just make the macro in those countries a little slower to play out than it is in the US.

Then on your point about promotional environment, I would encourage you to think about the promotional environment as being more a marketing phenomena than a margin phenomenon. And you see that in our gross margin. And so what's happened is suppliers have had an excessive amount of goods, they then know that the replenishment cost is lower, and they know that they can bring in goods at a much lower price, and they know that getting there, puts them in a position to be a winner and take share because they're going to be much more aggressive on price.

So if they hold pricing based on their cost basis, they would end up being the last person to get there and they don't want to do that relative to their peers. So you're seeing them price to some degree relative to the replenishment cost. And so that's why costs keep coming down. It's also why it's already come down some.

Well, then what we're doing from a marketing phenomena is we're saying that, hey, customers, they're just seeing negative headlines. Rates need to keep going up. Housing prices have fallen the most in a long time. There's a war that doesn't seem like it will end. You can't find positive headlines very easily nowadays. And so, the phenomenon with customers, they tend to then kind of sit on their hands and the layoffs that are happening in certain sectors certainly don't help that.

Well, what then happens is, if you tell them, hey, there's the sale of it, it's got great value. Turns out the top three quintiles of customers actually have an incredible amount of savings. They still have significant excess savings from pre-COVID. That message caused them to be curious. They come, check out what's available. They see items that they're getting excited by. They see the pricing being attractive. Then what happens is they find something that like and they buy it, because they have the money and the sale of it gives them both curiosity come check it out and then the permission to buy it, because the value won't last.

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And so I think that environment will last for a period of time based on effectively how the headlines play out. It's a period of time based on the psyche out there. And we saw this after the financial crisis. And so in 2009, 2010, there was a lot of this. And by the time you got into 2011, it really had abated, but it lasted a while. And we kind of know how to measure for that, because we don't want to keep that messaging once you get back to a normal environment. You don't want to create fatigue.

And on the other hand, you want to lean into what the customers want to hear. And so we're seeing that. And so that's playing out very well. We're seeing that in the customer reaction and the demand. And particularly, if you look at the order count, which is basically a proxy for the number of customers engaged and buying from us, you see it right there.

Ygal Arounian
Analyst, Citigroup Global Markets, Inc.

Q

Great. Thanks. And a quick follow-up. Kate, we're pulling a lot of costs out of the system here. And I just want to maybe dig into your comments that you're prepared to take additional actions like you said, depending on the environment, but how you think about your where cost profile is now versus where it might be? And where else there's room left to pull some levers if you do end up design to do that? Thanks.

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

A

Yes. So we feel very good about our current cost cutting. We've taken out about $1.4 billion of costs out of the business, actually over $1.4 billion. And as we've done that, we've looked across every line item of the P&L. And so that's from our gross margin line all the way down to our SOT G&A line.

What we've tried to do, and I think we've been really thoughtful about are we moving places where we were inefficient. You heard Niraj speak about this in his remarks and in some of the earlier questions, we've taken out management layers. We've taken out places where teams are focused on lower order priorities. We have not impacted any of our growth vectors. And I think that's very important to underscore.

In an environment where you saw a need to further cut, I think that will come in the form of sequencing things. Right now, our work has been all around improving efficiency, and we're excited about the gains that we think we'll get from that efficiency improvement. I don't know, Niraj, if you have anything to add.

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

A

The only thing I'd add is just one sentence I tried to allude to this earlier, but the decisions we've already made, the actions we've already taken, the things that are underway actually get us to our profitability and free cash flow goals in a wide range of revenue outcomes already. So I wouldn't say that we've underwritten a sort of case that you'd call bullish that needs to play out on the top line to get there. So we feel very good about where we sit.

Ygal Arounian
Analyst, Citigroup Global Markets, Inc.

Q

Thank you.

Operator: Our next question comes from Atul Maheswari from UBS. Please go ahead. Your line is open.

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Atul Maheswari
Analyst, UBS Securities LLC

Q

Thank you. Niraj, The reason why you're not providing a firm time line on EBITDA breakeven, whether it's second quarter or third quarter, is the reason that you're not providing that, is that because there is a lot of uncertainty in the macro, so you don't know how your top line is going to play out? Or are there other moving pieces that could move this [ph] time line out (00:41:22)?

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

A

I mean, while you can say, there's always moving pieces, I think we have a pretty firm view of how it will play out. I think we've just stuck with our traditional stance for eight years now of really not trying to provide a lot in the way of guidance. So we comment on the current quarter and then we really focus on sharing where we're headed and the trajectory, the decisions we're making, the priorities we have and we just tried not to spend a lot of time. I'm sure it's frustrating, but trying to tell folks how to model one quarter, two quarter, three quarter, four quarter. And I think we think that's better for focusing people on how the business will play out over time. That's really the reason.

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

A

Yeah. Atul, this is Kate. I just reiterate that we feel confident in our path to adjusted EBITDA breakeven. And we are focused on those cost line items. Clearly, revenue could be an accelerant one way or another. But even without that, we're committed to hitting it sooner than we had disclosed on the Q3 call in November. And then we're just reaffirming what we said in our press release in January.

Atul Maheswari
Analyst, UBS Securities LLC

Q

Got it. And then just a quick one on the free cash flow. I know, you've reiterated that the EBITDA breakeven is going to be earlier than the fourth quarter. Should we expect free cash flow positive by at least the fourth quarter?

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

A

So again, we don't guide to free cash flow positive, but let me give you a few thoughts on that, that may help how you frame the thinking. So first, I'd point you to this quarter, where we were essentially free cash flow breakeven, down only about $19 million on free cash flow. And some of that is due to the working capital seasonality of our business.

We operate on a negative working capital cycle. And so quarter-on-quarter of sequential positive growth, working capital will be a use of cash. As what I mentioned on the call, Q4 to Q1, which is historically a period of quarter-on-quarter revenue decline, working capital will once again become a use of cash rather than a store.

So as you model out the year, there's both the working capital dynamics and how those may play out based on our traditional seasonality. And then there's the work we're doing to aggressively manage operating cash flow and continue to manage down those costs. And so I would think about the two of those things in conjunction if you think about free cash flow going forward.

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Atul Maheswari
Analyst, UBS Securities LLC

Q

Got it. Thanks a lot, and good luck with the rest of year.

Operator: Our next question comes from Seth Basham from Wedbush Securities. Please go ahead. Your line is open.

Seth Basham
Analyst, Wedbush Securities, Inc.

Q

Thanks a lot, and good morning. There's still nice improvement in orders per customer, but we're also seeing still elevated customer churn. How are you thinking about customer churn rates in 2023 relative to the last couple of quarters here in 2022?

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

A

Yeah, Seth. Thanks for the question. We're actually seeing very nice traction with our customers. I tried to reference that. I mean, I think order count would be your proxy for customers being engaged where folks are basically buying, right. And that – an order is the best proxy for a future order.

And so the way to think about that is when the recipe was not intact, it obviously was less compelling for customers to return. Now the recipe basically, again, to sequence it, right, availability got better in the spring last year. Speed got better in the summer. And in the fall, the retail prices got better. That got the full recipe intact. And obviously, having very compelling retail prices is key.

During that period of peak inflation and supply chain scarcity, we were not able to have as compelling retail prices as we would like. We do now. And so you've seen in the fourth quarter, you've seen the customer count and the order count grow. That's a trajectory that's continuing. So if you play that out over time, I think you're going to see certain numbers go in the direction that we certainly want to see them go.

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

A

Yeah. I think I'd clarify one thing, Seth. So I think you're looking at our active customer count. As I remember, that's an LTM figure. So what you'll see happen there is customers cycle out that as we're anniversarying some of those COVID periods that were still elevated in the past 12 months. I think you're actually seeing the declines there moderate in the fourth quarter, and that's part of what Niraj spoke to in the orders being elevated as you start to bring on some new customers.

We also disclosed a stat in our investor presentation, which we updated and released today that builds on our total customer file of customers that have ever purchased from us at being 80 million strong. Obviously, our e-mail list is far greater than that. And we continue to see this as a source of strength that particularly in an environment where 1P marketing becomes important, we can go back to this group and get them to shop again. So, that active customer number is a little wonky in the LTM basis that it's on.

Seth Basham
Analyst, Wedbush Securities, Inc.

Q

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Got it. Yeah. That $80 million that is interesting, but also implies that you've touched the majority of home purchasing households in the US, and you think that, that still is active ground to reacquire those customers as opposed to customers who have already experienced Wayfair and will come back?

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

Seth, we think there's actually a lot of folks we also have not yet had purchased from us, because remember, that $80 million would include not just households or consumers, it would include the B2B customers. And the Wayfair Professional business is a smaller piece of our total business, but meaningful and it would include all the international geographies, both B2C and B2B as well.

Seth Basham
Analyst, Wedbush Securities, Inc.
Q

Got it. Thank you.

Operator: Our next question comes from Steven Forbes from Guggenheim Partners. Please go ahead. Your line is open.

Steven Forbes
Analyst, Guggenheim Securities LLC
Q

Good morning, Niraj, Kate. Niraj, I wanted to start with international profitability. And really just curious if you could take a step back for us and maybe just reframe how you're thinking about the near-term and medium-term opportunity for the free cash flow needs to support those initiatives. And then maybe, Kate, if you can help us frame how the cost actions impact the segment disclosures, right? In essence, as we think about international profitability into the first quarter.

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

Yeah. Sure. Steven, thanks for the question. The way to think about – so first of all, the international segment is the compilation of Canada, Germany and the UK. And those three countries are each at different stages of maturity, Canada being the most mature household brand, significant penetration there. The UK is second household brand, leadership role as well, very nice penetration, not quite as high as Canada. And then Germany would be the least mature of the three, not quite a household brand status kind of on the way.

And then each of those three are in a different macroeconomic environment. All three kind of similar to one another, more challenged in the US, stronger first half last year off the COVID, sort of, environment in the US, but different than each other as well. And so the trajectory on international profitability – each of those countries has a nice trajectory on the path to get there. And then you add it up and you'll see that total segment. So it's not like one thing, but let me turn it over to Kate, who maybe can answer your question about how to think about [indiscernible] (00:48:37).

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

Yeah. I would think about the cost cutting that we did as being expansive across our entire portfolio of brands and geographies. So it wasn't as if anything was excluded from that work. So the cost cuts that we've talked about on

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– for example, on the compensation and the [indiscernible] (00:48:57), those were related in Europe as well, where we have a team on the ground. We obviously don't have a large team on the ground in Canada.

Similarly, the operational cost savings that we're making, those are impacting our international businesses. We also spoke in our press release about savings relative to plan on our advertising spend and capital expenditures. And again, those also apply to our European business and our international portfolio as a whole. So when you think about the cost savings, you should think about them as being broad-based, and we're scrutinizing every area of the business.

Steven Forbes
Analyst, Guggenheim Securities LLC

Q

Thank you. And then maybe just a quick follow-up to Seth's question. I took you guys putting that slide in there in the presentation, the customer filed $80 million. I'm not sure if you're trying to indicate something, but maybe Niraj, you can sort of speak to your reactivation efforts of the lapped customer base? And then, I guess, most importantly, as we think about that LTM number that gets disclosed, have we reached a point at where you can sort of predict or foresee internally the return to active customer growth as that disclosure is defined?

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

A

Yes. So few thoughts. So one, that LTM number, obviously, if you believe that on that order count and the recipe being intact, so these things have turned, it then takes a full 12 months before that number reflects a full year's worth, right. So that's one thing.

Second thing is that number, the definition of the active customer numbers bought within the last 12 months. So there's different kind of levels of engagement. There's people who have not shown up on the site at all. And then there's folks who visit on the site. And so there's some stats in the investor deck as well on that. So I think we said that the site and app visits last year were 3 billion visits.

So if you take the active customer number, you divide it by the visit number, the number of visits you would get per customer would seem incredibly high, which basically tells you that, that's probably unlikely right, which means that there's a lot of people who visited who haven't yet bought. And so if you say, oh, the recipe is back intact, they're doing things that seem to be working. Customers are reacting.

Well, the conclusion, I would think you would draw is, that there's a lot of other people who are getting more engaged and have become co-engaged who haven't yet bought. So the way to think about that is that there's a cohort coming along, which is not just in the active number yet, but it's more engaged and coming behind them. I mean, on reactivation, obviously, we think about that a lot.

The COVID period had a very unusual shape to it with the Q2 of 2020 being this huge spike up. So, there's a lot of people who've had different levels of engagement. But if you look at it in a more recent period, you see this nice upswing of people who both bought, which is in the number, and people who have not yet bought but would be in the visits and the app visits type number.

Steven Forbes
Analyst, Guggenheim Securities LLC

Q

Thank you.

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Operator: Our next question comes from Anna Andreeva from Needham. Please go ahead. Your line is open.

Anna Andreeva
Analyst, Needham & Co. LLC

Q

Great. Thank you so much and good morning, guys. We wanted to follow up on the guide. You said you're seeing normal seasonality, but the 1Q guide implies a trend that's below the historic seasonality for the business. So is the takeaway for us that January perhaps started off slow, but the trend has improved in Feb. Any comment on how President's Day played out for the business? And thank you so much.

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

A

All right. So Anna, let me answer – let me just say a couple of thoughts, and then I'll let Kate opine. So, if you look at the year, if you forget about what happened last year, you look at the year, you're seeing a very nice seasonal pattern, which is strong since the beginning of the year.

If you compare it year-over-year, the percentages shift and they shift not because of what's happened this year, but because of the shape of the COVID-related excess demand around the Omicron spike last year. So it's all in what frame you want to put on that.

From a predictive standpoint, the seasonal cadence would tell you more than trying to do the mathematical formula of the COVID spike on Omicron and the down slope of Omicron and what happened next, et cetera, stimulus, et cetera. But Kate, I don't know.

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

A

Yeah. I guess I would just point you to, I think what we said was that we were seeing seasonality in our core business. So as you think about our US Wayfair business.

And then the other thing that I would add is from a seasonality perspective, we do typically see the outdoor season start in March. That is generally what is, is sort of guiding that pickup in March as we hold to the seasonality that we're seeing. And then, that's how we end up at the guide of negative high-single digits versus where we are quarter-to-date.

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

A

And I'll just say, we were very happy with President's Day, so that did go well.

Operator: Our next question comes from John Blackledge from Cowen. Please go ahead. Your line is open.

John Blackledge
Analyst, Cowen and Company

Q

Great. Thanks. Two questions. The ad expense as a percent of revenue has been elevated the last few quarters and into 1Q as well. Kind of what are the drivers? And how should that track over the course of the year?

And then the second question is, could you discuss the key drivers of the market share gains in 4Q. Do you think they're kind of – you're kind of holding those share gains thus far in 1Q? And at a higher level, kind of, what would

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it take for Wayfair to get back to the pre-COVID incremental market share gains, which at times, I think you disclosed were as high as 20% or 30%? Thank you.

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

Thanks, John. So on your first question about the ad cost, and I think you're looking at the ACNR, so as a percentage of revenue being elevated. I think the best way to think about that is, that percentage reflects a mix of free traffic, which has zero cost. So this is people coming directly to Wayfair, people who have the app and open it, people click on an e-mail, et cetera and paid traffic. And this is like the paid media spend that you're all familiar with as well.

And in a period of time where the category is not top of mind, and since last summer, that demand easing as we went into last summer was basically a function of discretionary spending shifting to travel, leisure and entertainment. And so you see that being above trend, and you see this category being below trend. And that's just reflective of this category in being less top of mind. Those are the categories being more top of mind. You see free traffic get softened.

The paid traffic, though doesn't necessarily get soften, because we manage that very quantitatively around paybacks. And in fact, if anything, we've heightened the paybacks by cutting out some of the ad spend that was more speculative that would be the highest ACNR ad spend, which is one of the things we referenced in the $1.4 billion of cost actions.

So what you're going to see is ACNR, of course, gets better just off cutting out that ad spend. But frankly, the biggest thing that will make it better over time is that sort of category getting back to the mean and that sort of – the free basically is a proxy of that recovery, whereas the engaged base, but the question is how top of mind is the category? And so that will play out. And we're seeing, as I mentioned, some nice signs in the business, as I mentioned, on the recipe and on the traction of the seasonal cadence.

On your second question about the market share in the fourth quarter, I would not say the market share got better in the fourth quarter, I'd say the market share got better starting in the fourth quarter. And so we believe that we're doing well. We believe we're doing well this quarter. We just came off a lot of trade shows at the beginning of the year has a tremendous number of supplier trade shows. And what we've heard from suppliers is the feedback that they saw us taking share starting in the fourth quarter. They've seen us continue to take share this year.

We believe we're seeing that in credit card data. And so we think that recipe being intact and then all the things we're doing around leading in to providing the customers with value, helping our suppliers deliver that value, that it's working. And so we feel very good about how that will continue to play out. And as you roll forward, we're very confident in how our results will play out. Kate, anything you want to add to that?

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

No, I think that covers it. And I think that was our last question.

John Blackledge
Analyst, Cowen and Company
Q

Thank you.

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Operator: We are out of time for questions today. I would like to turn the call back over to the Wayfair team for closing remarks.

Niraj S. Shah

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

Thanks, everybody. I'll endeavor to have my voice back for the next call. And thank you all for joining today.

Kate S. Gulliver

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

Thanks all.

Steven K. Conine

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

Thanks.

Operator: This concludes today's conference call. Thank you for your participation. You may now disconnect.

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