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Wayfair, Inc. (W)

Q1 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to Wayfair Q1 2023 Earnings Release Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] And finally, I would like to advise all participants that this call is being recorded.

Thank you. I'd now like to welcome James Lamb to begin the conference. James over to you.

James Lamb
Head-Investor Relations, Wayfair, Inc.

Good morning and thank you for joining us. Today, we will review our first quarter 2023 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 second 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, our 10-Q for this quarter, and our subsequent SEC filings identify certain factors that could cause the company's actual results to differ materially from those projected in any forward-looking statements made today.

Except as required by law, we undertake no obligation to publicly update or revise any of these statements whether as a result of any new information, future events, or otherwise.

Also, please note that during this call, we will discuss certain non-GAAP financial measures as we review the company's performance, including adjusted EBITDA, 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 pleased to reconnect with you today to share the details of our first quarter results. Last August, we shared a roadmap laying out our path to profitability. The first step was getting back to adjusted EBITDA breakeven.

We're focused on our three core initiatives of driving customer and supplier loyalty, nailing the basics, and cost efficiency. We've made significant strides in improving our offering and customer experience, while simultaneously reducing our cost structure. Collectively, these efforts have resulted in increasing market share and a significant reduction in operating expenses versus last quarter, getting us to nearly adjusted EBITDA breakeven in Q1. And we're excited to share that we expect to have positive adjusted EBITDA in the second quarter.

We've always known and now we are clearly demonstrating that the Wayfair model is inherently profitable and that there is considerable opportunity in front of us to rapidly drive further margin expansion, while investing for future growth.

We've reached this profitability milestone in spite of the difficult macro environment our business has operated in for the better part of a year. Our category, in particular, has been impacted more than others, with sales first trending down in March of 2022 and now contracting approximately 20% year-over-year according to many of the sources we follow.

While traffic remains challenged, our conversion levels have held steady and our work on nailing the basics and driving customer and supplier loyalty is leading to sustained market share growth.

In the second quarter, we're seeing improving year-over-year order trends, and we're just coming off the back of our seventh Way Day event. At the beginning of the year, as we planned a denser promotional calendar for 2023,

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we decided to try a three-day format for Way Day. We are very pleased by the engagement from both our suppliers and our shoppers to the extra day.

It's a testament to the hard work and the quality of execution of the team that our model of fast delivery, great availability and sharp pricing, is firing on all cylinders, even as we are making meaningful adjustments to our cost base.

As we've done for several quarters, I want to update you on different parts of the business in the lens of our three key initiatives, starting with cost efficiency. As part of our $1.4 billion total annualized cost actions that we outlined in January, you've heard us refer to $500 million coming from operational cost savings.

These cost savings initiatives are multi-fold and manifest across all aspects of our value chain. As we're now starting to see some of the benefits of these savings flow through in our gross margin, I want to take a few moments to share some further examples of these initiatives and provide you some more perspective on our progress.

As we started down the road of driving cost efficiency, our overarching goal was to actually enhance the customer and supplier experience, even as we looked for areas of savings. One of the ways we do that is by reducing damage rates, both on specific products as well as in the aggregate.

In instances where we see rising incident rates, we take a proactive stance in working with our suppliers to identify specific weak points and improve packaging. Our strength in data science and technology allows us to take this to the next level, using information on damage rates to compose better search results for shoppers. This is one of many factors that has driven our overall incidence rate down by over 15% since last summer.

By prioritizing items that we know consistently delayed our shoppers, we create a better experience, save on after order service expenses and driving much higher likelihood of generating a repeat order in the future.

Lower cost of delivery directly translates to lower retail prices for consumers. So another area that we focused on recently is optimization of our last mile costs. Every product sold on Wayfair is classified as either a small or large parcel, though to set expectations, our small parcels average 30 pounds and can actually go as high as 150 pounds in some cases.

Our small parcel orders are shipped through carriers like FedEx and, as you would expect, are less expensive to deliver than large parcel items, most of which are fulfilled through our middle and last mile Wayfair delivery network, where all trucks are staffed with two-person teams, rather than just a single driver, due to the heavy and bulky nature of the products.

Many items will straddle the line between small or large. So we've sharpened our data analytics tools that decide whether a product is classified as a large parcel or not. For some items, large parcel clearly makes sense. The higher cost of delivery is more than offset by the reduced damage rates from the extra care.

In other cases, we may see that shipping times and damage rates are indifferent, in which case classifying the item as a small parcel creates a more compelling retail price, while preserving the customer experience.

Our ability to optimize shipping costs has been further enhanced by our efforts to drive more suppliers through CastleGate, with multiple benefits that accrue to the customer and to Wayfair. Improved forward positioning means fewer logistical touch points and, therefore, less fulfillment expense, while also resulting in a lower risk of

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damage and faster delivery times. In fact, the percentage of items on the site with speed badging hit a new record high in the first quarter of this year.

These are just two examples across a multifaceted initiative, with more than 70 distinct areas of savings, all of which adds up to the more than $500 million I mentioned earlier. In a few minutes, Kate will talk more specifically about the financial flow-through here, but I want to acknowledge the speed and thoroughness with which our team has executed on these work streams.

Since we started this process last summer, we've now achieved more than half of the targeted savings on an annualized basis and are making steady progress towards completing the remainder by year-end. These are durable process-oriented savings that we expect will create improved economics and efficiency on every single order placed and which we believe will lead to higher savings when the volume growth returns.

I mentioned it earlier, but it bears repeating. We're extremely proud that, even as we have driven these considerable changes across our business, we are still seeing strong market share expansion.

Our second key initiative is driving customer and supplier loyalty every day. And the best evidence of our progress here comes from the market share picture. We collect market share data from several sources, such as conversations with our suppliers, third-party research and credit card data.

The picture we are seeing across all sources has unified over the past several quarters, a clear and resounding win in share for Wayfair. YipitData, one of the major credit card data providers, recently published their publicly available first quarter Home Goods Market Share Index for the United States, which shows us in the number one position with ongoing share capture for several quarters.

A similar story is playing out in our second largest market, Canada, where we have seen robust share capture since last summer, as we made big unlocks to speak more specifically to our shoppers in the region. Across our efforts to drive customer loyalty, we recently launched filters to search for products fulfilled from Canada, which our customers in the region love and are highlighting items that are positioned within the country.

Our Canadian customers appreciate the added benefit of surfacing items with faster delivery speeds, competitive retail prices and lower incidence rates. We've also launched a best-in-class French experience for our Wayfair.ca shoppers and host Canada-specific promotional events like Victoria Day and Canada Day sales to speak more directly to our customers in the country. During these moments, we have partnered with Canadian influencers and celebrities to further connect with our shoppers and offer them items they will love.

As with the US, our core recipe in Canada has never been in a better place. Strong availability, competitive pricing and fast delivery have kept customers coming back. And this ties nicely to the third of our key initiatives, nailing the basics.

In that spirit, we recently enabled detailed end-to-end international tracking on Canadian orders that originate from the United States. Most shoppers previously could only see the detailed location of their northbound order once it had crossed the border. Our Canadian customers now have full visibility to where their items are at each stage of fulfillment, which reduces the volume of post-order service inquiries.

On the theme of service, we've also strengthened our Canada-based customer service team. We find that having domestic agents, who understand the unique needs of their local shopper, reduces the number of follow-ups and immediately improves the customer experience, the true meaning of nailing the basics.

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As I wrap up, I want to zoom back out for a moment. For several quarters now, we've laid out a road map for our return to profitability. Along the way, we told you that we intend to be both thoughtful and expeditious as we chart out this journey.

And while we still have more road ahead of us, we see our progress over the past nine months as a true proof point that the plan is working. We're as confident as we've ever been that Wayfair will emerge stronger for it on the other side.

Now with that, let me hand it over to Kate to walk through our financials for the quarter.

Kate S. Gulliver

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

Thanks, Niraj, and good morning, everyone. I want to echo Niraj's enthusiasm at the promising signs we are seeing for 2023. Our team has been working hard to execute the plan we outlined in 2022, and we couldn't be more pleased to see the output now beginning to manifest in the results. So let's dive into the first quarter figures.

Net revenue for the quarter came in at $2.8 billion, down 7.3% year-over-year. We are seeing a return to more traditional seasonality in our business and are encouraged by the improving trends we see in order growth. As we shared before, we expected order volume and active customer count to pick up as inflationary prices abated, and we are starting to see evidence of this dynamic playing out.

The picture between our geographic segments remains largely unchanged with net revenue in our US segment down 5% year-over-year, and our international segment down 14.4%, excluding the impact of FX.

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

Gross margin had another stellar quarter, coming in at 29.7%, even as we maintained a robust promotional calendar. Our team continues to make meaningful headway on our operational cost savings, as Niraj discussed, and you are beginning to see that flow through to this line.

Niraj described these savings as process oriented, meaning they will hold and, in some cases, improve as our volume increases, and he noted that we've achieved over half of our targeted annualized savings. Some of which we're starting to see show up in gross margin, while the rest we have passed on to price. It's important to note that we see these savings as structural margin expansion on the road map to our longer-term target gross margin in the mid-30s range.

Last quarter, I mentioned that as we see these savings begin to accrue, we may choose to reinvest some of them in the customer experience through sharper pricing. The mix will be dictated by the macro environment we see over the duration of the year. However, I think one important point to make here is that our operative goal is to maximize the gross profit dollars generated across a multi-quarter horizon.

We can do this in two ways. The first is passing the savings directly on to incremental gross profit, driving a higher gross margin. The second is to sharpen our pricing, letting the operational savings offset the impact from a reduced take rate, effectively netting out to a gross margin that remains unchanged, but one that results in more orders and more repeat business. We will balance this dynamic to keep driving optimal outcomes over time. Our

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plans are to reinvest some portion of further savings in price in order to drive more volume and maintain and grow our share position while also balancing gross margin expansion.

Moving on to customer service and merchant fees. We saw this line come in at 4.7% of net revenue in the first quarter. Advertising was 11.8% of net revenue as we are driving even better efficiency out of our paid channels, while we continue to face the same headwinds on the volume of free and direct traffic that we've seen for several quarters now due to the macro environment.

Finally, our selling, operations, technology, general, and administrative expenses totaled $484 million. As a reminder, the majority of this expense line is related to our people and the remainder covers software and other G&A.

You are seeing the majority of the savings from the January reduction in force reflected in this figure. And you should expect to see this number show further moderation in Q2 as we fully run rate the cash compensation piece of the $750 million of annualized labor savings that we have now completed.

However, we don't see this at the end of our cost savings journey on SOTG&A and we plan to drive low single-digit sequential compression each quarter through year-end on top of what we've already accomplished.

All combined, the outperformance on gross margin and advertising as well as strength in the topline, contributed to a significant improvement in adjusted EBITDA and negative $14 million this quarter or nearly breakeven, a substantial improvement compared to the negative $71 million in Q4 2022 and negative $113 million in Q1 2022.

Our US business saw second consecutive quarter of positive adjusted EBITDA at $29 million and we nearly have the international adjusted EBITDA losses compared to Q4. We are excited to see the tangible benefits of our cost savings work materialize and we remain tightly unified around our future profitability goals.

We ended the quarter with just over $1 billion of cash and highly liquid investments on our balance sheet and over $1.6 billion of total liquidity when including our revolving credit facility capacity. Net cash from operations was a negative $147 million and capital expenditures were $87 million, resulting in free cash flow of negative $234 million.

As a reminder, the first quarter is almost always a seasonal cash outflow quarter for our business given the negative cash conversion cycle of our working capital following Q4 holiday peak.

Now, let's turn to guidance for the second quarter. Quarter-to-date gross revenue has been trending in the negative high single-digits year-over-year, and we expect improvement due to the easier compares in May and June. We've also spoken recently to you about sequential trends and seasonality, and this trend would imply Q1 to Q2 sequential growth of just below positive 10% for net revenue.

Despite the highly uncertain macro environment and the reduction in AOV due to deflation, we are excited by the ongoing improving trends in order volume and are seeing promising signs in the business.

On gross margin, we would guide you to the 29% to 30% range that I framed earlier. We continue to expect customer service and merchant fees to be between 4% to 5% of net revenue and advertising to be between 12% and 13% for Q2.

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We forecast SOTG&A or OpEx, excluding equity-based compensation and related taxes, to come in between $460 million and $470 million, showing some further improvement from Q1 levels as we fully run rate the savings from earlier in the year.

So, finally, as we've said several times already, if you follow the guidance I've just outlined, you should see positive adjusted EBITDA margins in the 0.5% to 1.5% range for the second quarter.

Based on that range on adjusted EBITDA and the working capital dynamics, as we move into the spring, you should see a sizable sequential improvement in free cash flow for Q2 relative to Q1.

We are now reaching the first stage along our profitability path that we set out last August. So, I want to touch on how we are thinking about the next stage, reaching mid-single-digit adjusted EBITDA margin and positive free cash flow.

Let me provide an illustrative model to frame the full pro forma impact of the cost savings that you're seeing starting to flow through. To be clear, this isn't meant to be official guidance, but a framework to think about our cost initiatives holistically.

For simplicity, let's use our revenue level from 2022, roughly $12.25 billion top line and apply the pro forma annualized impact of our cost savings initiatives that are already well underway and will be fully enacted by the end of 2023.

At that level, we would expect to see adjusted EBITDA margins in the low to mid-single-digit range as gross margins exceed 30% and SOTG&A reaches between 14% to 15% of net revenue, due to the ongoing savings work I mentioned above. At that point, we have a cost model that is geared for significant leverage when revenue grows in the future, and we expect that many of our operational efforts will enable the next set of improvements on our road map.

As we've said several times in the past, once we hit a mid-single-digit adjusted EBITDA margin range, we intend to treat that as a philosophical floor on profitability for the business, from which we will then balance any growth in investment spending with a desire to also continually increase profitability.

Now, let me translate that into cash flow. As many of you know, there are two major bridging items between adjusted EBITDA and free cash flow for our business, working capital and capital expenditures.

Our business operates on a negative cash conversion cycle, so working capital is a source of cash when revenue grows sequentially and vice versa. Thus, the impact of working capital will be entirely a function of your assumptions on revenue. If you assume capital expenditures at plus or minus $90 million per quarter, then the $12.25 billion run rate would also translate to positive free cash flow as well, absent the working capital dynamics.

Now, let me touch on a few housekeeping items for the second quarter. Please assume the following: equity-based compensation and related taxes of roughly $170 million to $200 million. This will be above trend in Q2 as a function of the seasonality of our compensation cycle.

As a reminder, equity-based compensation is expensed at the share price as of the day the grants are originally approved. As a result, a portion of this is related to historical grants that remain in the P&L at elevated share prices, given the share price volatility we have experienced. And the remainder will hit the P&L depending on the trajectory of the share price going forward on the date new grants are approved.

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Depreciation and amortization of approximately $102 million to $107 million, net interest expense of approximately $5 million to $6 million, weighted average shares outstanding equal to approximately 112 million, and CapEx in a $90 million to $100 million range.

Before I wrap-up, I want to take this opportunity to commend our entire team. Over the last nine months, we've delivered tremendous cost efficiency, while at the same time bringing our offering to the strongest place it has been in years. We are excited about the improvements we are seeing in profitability and optimistic that the success of our core recipe will continue to drive our share gains deeper into 2023.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Alexandra Steiger from Goldman Sachs. Your line is open.

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

Q

Thank you for taking my question. I do want to double-click on the comments around your Q2 revenue growth. How do you think about the key drivers here? What create upside versus downside in the trajectory for Q2 including the contribution from an extra day for Way Day? Or put differently, could you maybe walk us through the assumption around customer growth, order growth that went into your guide? Thank you so much.

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

A

Hi, Alexandra. Thanks for your question. Yes. So, I guess the way to think about it is, in general, the first half of this year, the promotional calendar, we've picked a more dense one. We did that in the back half of last year. That's in response to kind of the consumer environment and sort of what consumers are reacting to.

And so when we planned that out at the beginning of this year, one of the things we did is we tried different formats last year. We ran [ph] two-day (25:19) Way Day events. Other times, we've run eight-day, six-day, five-day, three-day. We've run different sale lengths. So this year, we decided to try that sort of Way Day format of the two days and then the surprise extension. And we were happy with how that went. That's just one of kind of the many things we've done on the promotional calendar side in response to the macro.

In terms of the Q2 revenue guide, I mean, we're guiding revenue based on what we're seeing happen, and a lot of that has to do with also underlying drivers in the business. Because it's – you have the revenue level, but you have kind of what's happening. You mentioned kind of order count and customer count. And what we've been seeing, and you kind of see in our active customer numbers, is sequentially, we're seeing the sequential pattern hold. And sequentially, we're seeing strength in the business and the core drivers.

And so for example, if you look at order growth, if you look at our largest brand, Wayfair.com, it has positive quarter-to-date in Q2 year-over-year order growth. And so there's a lot of different metrics that sort of we're able to see that led to effectively the guidance we've given.

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

Q

Very helpful. Thank you.

Operator: Your next question comes from the line of Chris Horvers of JPMorgan. Your line is open.

Christopher Horvers
Analyst, JPMorgan Securities LLC

Q

Thanks and good morning. So, just touching on that seasonality point. As you think about what you're seeing now, especially compared to a lot of other retailers, I think when all is said and done, they're going to have a pretty tough first quarter here. How are you thinking about that seasonality and the prospect of returning to revenue growth at the enterprise level over the next year?

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

A

Hey, Chris. Thanks for your question. Let me throw out a couple of thoughts and maybe Kate can chime in with some more thoughts of hers as well. I think the biggest thing to keep in mind, when you talk about returning to growth, is through the first half of this year, we still have unusual revenue compares because we didn't see kind of normal seasonality and normal – kind of we didn't see revenue kind of normalize after sort of the wonky COVID years until the middle of last year.

So, once you get to the middle of this year, if you go through the second half of this year, you now, when you think about year-over-year revenue, you have a kind of a base from a year ago that's normal and you have then what's happening now. And as I mentioned, quarter-to-date, for example, on Wayfair.com, orders are up year-over-year.

And while that's not the entire enterprise, and that's just one metric, it sort of gives you a feel of what's happening as we're getting to more of those normalized comps. So, I think honestly, it's – the key is that our recipe is working. So, what is that? That's availability, speed of delivery, great value. We're continuing to make a lot of improvements in the customer experience.

We're seeing good traction and customer reaction to that. We're then, I think, doing a good job from a kind of what are we offering a customer in terms of I mentioned the promotional events and how are we sort of responding to what the macro climate is and working with our suppliers to create that excitement.

And then I think from a technical point, you need the normal year ago period in order to have the revenue kind of play out where the sort of – if the business is growing, you see growth. And if it's not growing, you don't see growth. Well, you kind of need last year to be normal, too.

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

A

Yes. I guess what I'd add to that though, I think Niraj touched on some of the seasonality pieces. We're also obviously seeing ongoing sustained market share gains. And I think that really speaks to the strength of the core offering.

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And so to your point, Chris, the macro environment remains somewhat uncertain. We feel very good about our ability to continue to capture share in that market and the strength of the core offering is evidenced by things like order volume in Wayfair.com US turning positive quarter-to-date.

Christopher Horvers
Analyst, JPMorgan Securities LLC

Q

Yes. And then on the pricing front, can you talk about how you think about your strategy overall now? And is it different from what it used to be; i.e., you have these very fulsome savings on the cost of goods line. I think you used to try to price to market and not necessarily lead the market on price. How are you thinking about your pricing strategy relative to the overall market level now?

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

A

Yes, Chris. So, I don't know that our pricing philosophy is super different than what it's been for a long time, but just to be clear on what it is for – so we measure effectively the customer's reaction to our price levels. So, the price elasticity by different types of goods, different tranches of price. That is a factor in deciding what margin levels we use in different areas of the catalog.

One of the inputs to that is understanding competitively where the field is in terms of competitors at price because, obviously, that affects the price elasticity kind of dynamic as well. When goods get to be more heavily branded, the elasticity tends to reflect the need to be very tight to market on price. As goods get to be less branded and increasingly also exclusive, then there's a factor of kind of you guys need to offer the customer price value, but there's a wider band of how you can price. So, we try to do that quite scientifically.

And then the underlying thing we've been doing, which you cited, is we've been focusing on taking out as much cost as possible so that we can have the margin we want at retail prices we like and that's what we've been doing.

And so a lot of our ability, you've seen the gross margin has held – the gross margin's kind of – the way we've been able to improve the gross margin are all structural savings. So, they are not things that are fleeting at all.

And we feel like we can continue to actually unlock value in terms of savings, then we can choose. Do we pass those to the customer and get sharper on price or do we put some of it into our margin? And there's a balance of what we'll do.

But our philosophy hasn't changed, but we're in a much stronger position than we would have been when inventory availability was poor or, frankly, even before we did some of the things that we've done that have advantaged us.

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

A

Yes. I think the thing that I'd add to that, Chris, is as Niraj mentioned, we're really seeing nicely in Q1, the benefit of those operational cost savings that we laid out in January.

And that continues to be a lever for us that we can pull throughout the rest of the year as we balance both maintaining and ensuring ongoing price competitiveness in this market, but also flowing some of that through to the gross margin line.

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And as we said on the call, we're very focused on generating gross profit dollars over a multi-quarter period. And I think you'll see some of that balance play out through the rest of the year.

Christopher Horvers
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you very much.

Operator: Your next question comes from the line of Brian Nagel of Oppenheimer & Co. Your line is open.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Hi, good morning. Congrats on the progress here. Nice work.

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

A

Thanks, Brian.

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

A

Thank you.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

So, a couple of questions. First off, Kate, you discussed in your comments, just I guess, the near-term kind of capital needs here, but recognizing you haven't necessarily given longer term guidance, but as we're looking at the business model and the business model continue to evolve here. I mean how should we think about kind of that longer-term capital needs of the business?

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

A

Yes. Thanks, Brian, for the question. So, I want to frame up how we think about CapEx and the components of it. There's three key components to CapEx. One is that line item that you see that site and software development costs. That's capitalized technology labor, so our tech team.

And you should see that line continue to moderate a bit based on the reduction in force that you've seen and the ongoing efficiency in our labor force. And I think you saw that show up a bit this quarter. That's about 60% of the total CapEx expenditure in the quarter.

The remainder, the PP&E is really related to two things; one, ongoing investments in our logistics infrastructure, that's really designed to provide increased efficiency out of that network. And two, the build-out of our physical retail network. So in this year, that's a Wayfair store that will open in the spring of 2024 as well as two specialty retail brands that will open this year. The sort of mix of those is roughly equal for the remainder of the CapEx.

You obviously saw that line moderate a bit in the first quarter, and we remain – as we do with every line item here, we're very focused on driving efficiency there and continuing to run that as tightly as possible.

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Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Okay. No, that's very helpful. And then my second question, unrelated, but you talked about just the – I'd probably say improving consumer metrics here that we're seeing early in 2023. Obviously, a lot going on with Wayfair and a lot of initiatives.

But, as you step back, I mean, how much of what you're seeing right now, in terms of improved consumer interaction, do you think is a function of specific efforts on the part of Wayfair versus maybe some easing on external pressures in this space?

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

A

Well, so let me answer that a couple of different ways. So, we're clearly taking market share. So, I think the outcome is relative to competitors, we're clearly doing meaningfully better because that's kind of like, I guess, the definition of kind of the market share.

As to the why are we doing better than competitors, I think it's less about what the competitors are doing, and it's more about what we're doing. And so when we mentioned that recipe, again, great availability, fast delivery, great retail prices and then kind of coupling that with all the things we're known for around customer service, an emotive shopping experience and product discovery and being tailored for home and kind of proprietary delivery advantage on heavy bulky items.

That's kind of what we've built the business on over 20 years. We had a disruptive couple of years in the middle. If you go back a couple of years ago, because the COVID phenomenon, while the beginning was a nice boon for our business, very quickly, it turned into a tough stretch when availability got tough. There's a lot of inflation, supply chain kind of short – it drove shortages of goods.

And our platform model didn't have the advantage that it has in normal times and in recession times. And most times or normal times or recession times, where you could argue whether we're in recession time now because there's an overstock of goods or whether we're in kind of more of a normal time because consumers do have money.

And so that could be semantics because clearly, the goods – the home goods market is not kind of on fire, right? It's down year-over-year and it's tough. But we have a great value proposition. And then as the market gets healthier, we're set up for that to be a big tailwind because of kind of how we operate. So, I do think it's due to our actions.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Got it. I appreciate it. Thank you.

Operator: Your next question comes from the line of Ygal Arounian from Citigroup. Your line is open.

Ygal Arounian
Analyst, Citigroup Global Markets, Inc.

Q

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Hey good morning. I want to dig into the gross margins a little bit, nice to see the outperformance. I just want to maybe get a better picture. So, I may have misunderstood, but I believe the way you guys spoke about the cost efforts is that they'll be more back half weighted.

And then it looks like you're starting to see some of those benefits right now. So, just – maybe on the cost efforts versus kind of organic improvements around pricing or normalization within that? And then if increased CastleGate adoption is driving some of the improvements there as well?

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

A

Great. Thanks for the question, Ygal. Let me start the answer, and then maybe Kate can also jump in on the thoughts she wants to add. And let me start by describing sort of the gross margin evolution over time because if you go back four or five years, we had a gross margin that was more like a 24% type number. And back then, what we were describing to folks is that we had and originally, we described three pillars and then we updated, described four pillars that was a runway of over 1,000 basis points.

And what those four pillars were, one was what we were doing in logistics which was building out our own proprietary logistics, which today comprises of both the inbound ocean freight leg through CastleGate forwarding, the CastleGate fulfillment operations, which is our warehousing capability and fulfillment capability and then what we're doing on last mile transportation, whether that be with partners through sortation and induction or whether that be our sales on the heavy bulky items.

And that, that could take out a lot of cost because excess miles both slows down deliveries, increases damage, but frankly drives up cost. So, it's a very complicated but exciting area because of how you impact not just the customer getting an item faster, but you take out costs.

The second of the four pillars was what we were doing around our house brands, which were basically our private label brands where we're creating curation, creating better merchandising experiences and also increasingly doing that with items that are exclusive or semi-exclusive to us. And that allowed us back to the question about how do we price and price elasticity, that allows us to have a wider band in deciding how we price and drives up conversion as well.

The third was just around how, as we concentrate volume with suppliers. And as their volume goes up, they can actually lower the price of the goods they sell, while driving up their profit dollars. And so it's a win-win for them and for us and for the customer because in that sense, we can basically choose to keep some gross margin or pass it on, and that creates very good dynamic.

And then the last, which is the pillar we added was around supplier services. And this was as we started to offer services to suppliers outside of just us buying at wholesale and selling at retail and selling their item. And outside of what we're doing on CastleGate, on the logistics offerings.

The most notable one of which is our advertising offering, where suppliers can advertise on our platforms to kind of drive their outcomes, and that's an ancillary high-margin revenue stream for us, which is still, frankly, still in its early days. It's growing nicely, but it's still early.

So, those four topic areas, we each said, had hundreds of basis points in them each. And over time, we're going to unlock them, and then choose what of that we put into our gross margin, what of that we passed on to the

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consumer, which would allow us, obviously drive long-term profits because the lower prices drives more conversion, drives future orders, repeat orders, dollars per customer per year, et cetera.

And so what we've been doing is unlocking that roadmap. And what I mentioned earlier is you have a couple of year disruption in here in 2021, 2022, due to how COVID played out. And so the roadmap we have before that is still the roadmap we have now. We're back along it and moving along it aggressively. And that is creating a lot of benefit.

So, then specifically now to zoom in on the kind of over $1.4 billion of cost actions or specifically the over $500 million of operational cost savings, which is part of that roadmap and how that plays out. What that is, is that is a reflection of us both being aggressive on the long-term roadmap we've had and specifically also addressing a lot of inefficiencies that have prepped in a lot of which during the COVID period, which, again, have thrown us for a loop, but we're sort of well passed now in terms of executing tightly, and we're unlocking those savings and you're seeing those manifest in the way that we described where we choose what we put into our margin versus what we do on the retail price.

But again, unlocking them in a structural way so we can keep this – so they just build on each other versus kind of ebb and flow. And so that's kind of how we think about it and kind of how it's playing out. Kate, do you want to add anything to-?

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

A

Yes, I think you hit on it nicely in terms of the broad picture. And specific to the quarter, to your question on CastleGate, what I would add there is that the cost savings that we're talking about in the operational network go across our entire logistics infrastructure. So that would, of course, include the CastleGate piece of that logistics infrastructure, and we're very pleased with how that's manifesting.

The other point that I make on gross margin while we're talking about it is – and that I think is a little bit unique to Wayfair is that we're able to improve this gross margin during what has been a highly promotional period for the customer.

And I think that shows the strength of our model and our ability to pass on that value to the customer, support, frankly, our suppliers who want to pass on that value to the customer, but do that well actually raising gross margin throughout 2022, and obviously, significant gross margin improvement this quarter and we expect that to sustain and grow from here.

Ygal Arounian
Analyst, Citigroup Global Markets, Inc.

Q

Great. Really helpful answer. And then I want to follow up on the capital allocation question a little bit more. And maybe balance it, Kate, you mentioned the physical store, opportunity investment there. Just trying to understand, A, on that front, what the kind of ultimate goal is when – what level of physical infrastructure is the right level that helps kind of build off of the online business?

And then maybe second on international, as margins there continue – certainly an improvement quarter-over-quarter, a nice improvement, but continue to be well below the North American business. So just how you think about the international business and the investment needed there? Thank you so much.

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

A

Sure. Ygal, why don't I start on the CapEx question and then Niraj can certainly chime in. So, on the physical retail piece, just to level set on where we are today, we have two specialty retail or three specialty retail stores open. The first is a small format sort of testing and helping us learn to model physical retail. The first large format Wayfair stores, we mentioned, will open in the spring of 2024 and we're opening two additional specialty retail stores this year.

As with all new initiatives, we are really in a test and iterate phase. So, we want to be prudent and thoughtful about how we roll this out, learn from these first few stores and then determine further expansion based on that.

But I think what you're seeing now is really us testing the model and starting to put a few players on the board there. I think Niraj probably can jump in on physical retail and then I'm happy to go back to your second question on the international margin trajectory.

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

A

I think I was going to touch on it slightly differently, which is also just to kind of zoom in on the beginning, what you said with our capital allocation questions. And by that, one way, I think, to answer your question is to think about this. The $1.4 billion of cost actions, that plan that we outlined was a plan that we think gets us back to being very focused, prioritizing the right actions, being very aggressive with that, making sure the recipe is intact.

But what it didn't do was we didn't try to say, hey, how do you cut the cost structure to really optimize the business, to maximize profitability today. What we left in is a very significant amount of expense on things that do not drive productive economic return today but we think could be meaningful in the future.

And international, for example, is losing money as a segment, but we actually believe that we have real potential there. We have a household brand in two of the international markets we're in. We have input metrics we like in those markets. We have a more challenging macro in some of those.

Physical retail, Kate mentioned super early, there, there's a lot of reasons, a lot of external proof around how omnichannel drives value. But we're in the early days. So, we're going to – right now, for example, we have a lot of CapEx going to open the first Wayfair large-format store. Obviously, that store today produces zero revenue. It's not open yet, right? And so that's an expense that we have.

And so there's areas of the business where we're aggressively investing for the future. And we think that, that's wise, but we think we can actually be meaningfully profitable while doing that. And so that's kind of the way we balance in. So we're going to be careful not to have too many places that we're investing because each one needs appropriate amount of focus and prioritization in order to really have a shot at succeeding and breaking through.

But we're also – we also are keeping that board of strategic initiatives that could be meaningful kind of there and investing in them in a healthy way so that they actually are set up to flourish. And that's kind of the way I think about it.

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

A

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Yes. The overall goal is invest and be profitable, right? We want to be driving profitable growth, and you'll see the sort of first marker on that in the adjusted EBITDA positive in Q2.

On international margins, specifically this quarter, obviously, what you've seen there is significant reduction in the losses. We just about halved the losses there. As we said on the last call, the cost takeouts that we've done has been across the board. We are focused on driving the profitability everywhere that we operate.

And as Niraj mentioned, we're pleased with some of the efforts that we see there. We spoke about Canada on the call and the market share gains in Canada and our prominence there.

And the last thing that I would add on those margins, just to keep in mind, we've spoken about this before, but we do have overhead allocation that goes both to the US and to our international business. And so as we reduce our overhead costs, which we've been obviously working very hard on, you'll see some of that benefit flow through the international EBITDA margins as well.

Ygal Arounian
Analyst, Citigroup Global Markets, Inc.

Q

Great. Thank you so much.

Operator: Next question comes from the line of Oliver Wintermantel from Evercore ISI. Your line is open.

Oliver Wintermantel
Analyst, Evercore Group LLC

Q

Yes. Thanks. If I look at the orders delivered, they're back to pre-pandemic levels using 1Q 2020 as that. And the order value is still bigger. There's probably some – still some inflation in there. If you look at that orders delivered number, is that now a good way to look at the business that back to pre-pandemic levels? And then on the order value, how much of that was inflation? Thank you.

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

A

Yeah, Oli, I'm trying to think what would be helpful, too. I mean I guess the way to think about it is on the inflation front, there's significant inflation. That inflation is well on its way of coming back out. And so one of the things we have mentioned is that starting a year ago, basically last summer, is really when the recipe got back intact. It started with availability getting better in the spring of last year. But as you went through the summer, speed got better. And then by late summer, price had gotten better.

And what was really happening there is a lot of that was suppliers recognizing that shipping costs, in particular, ocean freight, had abated and starting to price goods reflecting what their replacement cost of those items would be.

Now, that's going to take long, because there's lot of excess inventory they're working their way through and they don't necessarily price it all to the future price right away. But that deflation is coming through. So, there will be some deflation.

The thing I will point out, though, is this has been a question that we've gotten on prior calls as well, won't then the AOV decline be a drag on revenue. And one of the things we've pointed out is that what we've seen historically is actually that, that is an accelerant on conversion, effectively on order count and customer count.

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And so when you're creating the revenue outlook, you've got to take kind of customer/orders, multiply that by AOV, right, to get revenue. And it's – while it's not kind of the easiest math to kind of think through, there's a very direct correlation there, and that's what we're seeing play out.

And we mentioned orders, for example, on Wayfair.com are up quarter-to-date. And I think some of what's made comps hard is that, again, last year, first half had wonky comps. As those ease, we start easing here. And you get to the normal period, the back half of last year, that plays through. But I think these are, I think, the different moving parts.

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

Yes. I would just reiterate to your question, we should see order volume improvement, right? So, as the AOV, as you pointed out, which is still inflated, as that starts to moderate, we should see that order volume grow. And that then translates into customer growth. Those are the right underlying fundamentals, right?

We'd rather have order volume and customer growth and AOV growth on a sustained period as we can then remarket to those customers and they become engaged in the platform. So, that is a trend that we are encouraged by.

Oliver Wintermantel
Analyst, Evercore Group LLC
Q

Got it. And maybe in that regard, on the gross margin side, have you seen any price elasticity there? Like your gross margins have gone up, which is great, but the revenues are still down. Is there a way for you to maybe reinvest more in price and get the revenues and orders up? Or have you not seen the price elasticity when you reduce prices?

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

Well, this is what I tried to address earlier when I was talking about gross margin. That opportunity is definitely there, but we – that's what we're doing. So, in other words, we're continuing to unlock cost savings. We're then deciding what we put into price – lowering price and what we put into our gross margin. And there's kind of a pretty heavy roadmap there. So, there's definitely opportunity for us to continue and the plan is for us to continue to do that as we go through time.

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

Yes. Oli, as you know, we have a very sophisticated pricing model mechanism. So this is something that we constantly are pressure testing. We said we'd achieved about half of those operational cost savings. So there's more to go there. And we can make real-time decision on how much of that flows through to price, to your point, and generate future orders and how much of that flows directly through to gross margin. And that will depend a little bit on the market and what we're seeing with our customer.

Oliver Wintermantel
Analyst, Evercore Group LLC
Q

Got it. Thanks very much and good luck.

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

Thanks, Oli.

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

Anna Andreeva
Analyst, Needham & Co. LLC
Q

Great. Thank you so much and good morning, guys.

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

Good morning.

Anna Andreeva
Analyst, Needham & Co. LLC
Q

We had a quick question. Hi. One on active customers. You've seen some stability at the enterprise level in the last couple of quarters already. Just curious, what does that number look like for US only? Just any color, what are you seeing in terms of gross adds and churn in the US as some of the promo initiatives are clearly resonating with the consumer?

And then, secondly, I wanted to follow-up on advertising. So, your sales came in on plan and advertising was below the range you had provided. Could you talk about what you're seeing there with the efficiencies? And what is working specifically?

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

Yes, Anna. On the first question around active customers, I think we've tried to point out that sequentially, you're seeing that number start to stabilize. And we mentioned quarter-to-date on Wayfair.com, for example, order count is up quarter-to-date. In terms of the active customer count for the US, I'll let Kate comment on that. I don't know what we-

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

We actually – we don't disclose the breakout, but I think you're pointing to a trend that you can see in the revenue breakout across the US and the international business. And certainly, we've already mentioned the order piece in the US. That would probably naturally equate to customer improvements in the US business relative to the international business.

I think your second question was on ACNR leverage and how we're looking at that for the quarter.

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

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Yes. Kate, could I just jump in on that and then you can maybe add thoughts to it. Yes. So, on advertising, again, that $1.4 billion kind of over $1.4 billion set of cost actions that we outlined in January to help folks try to understand everything we've been talking about since last summer, but put it into context.

We cited advertising on there as one of the items. I think it was the third item on the list is in a group of some other things. On advertising, here, I think it's important to understand how we think about the ad cost because I think there's sometimes some misconception. And so I think the easiest way to think about it is think of it as having three buckets of ad cost.

And the first bucket, which is by far the largest bucket, think of that as kind of evergreen. And by evergreen what I mean is, these are different advertising channels that are highly measurable, that are run to very tight paybacks and that we are looking to increase our spend there.

But within that payback constraint, that's very tight and very measurable. And how can we do that? We can do that with targeting. We can do that with different creative ad units. We can do that by upping the conversion on the traffic and so that, we're continuing to maximize.

Then there's a second bucket, which is generally top of funnel type advertising. So, television would be kind of the poster child of this, but there's other things in this bucket. Those are channels that we can measure, but the error band around measurement there is larger. That you can't measure them quite as precisely as you can measure that first bucket. So, the measurement methods there are more triangulating on what you believe the values there.

So, inside that band, you could spend at the low end of the band or the high end of the band. And it would be within the band that you think is productive for the spend. But again, there's an error band there. And there, what we've done is we've biased towards being lower in the band rather than being higher in the band, and we're getting good results from that.

And then I think of the third bucket as an R&D bucket. So, these are advertising channels that do not yet operate at the payback we want them to, but we believe they could. So, we're experimenting in these channels, figuring out – trying to find breakthroughs of what works, what doesn't work.

And once you get to a productive approach there, we're getting the payback you want, you would then scale it. And these channels would then go into either bucket one or bucket two depending on what kind of advertising channel it is.

There, what we've done is we've taken a top-down approach and saying, hey, what percent of our ad budget or how many dollars are we willing to put into R&D? And then we take – we're now seeing that amount and deciding, well, which of these opportunities we see, do we want to invest in to get breakthroughs.

And we're kind of doing that top down rather than bottoms up. Because bottoms up, you're going to end up with many different opportunities, with many different ideas of what to test and it could add up to being a higher percentage of your total ad spend than you would like.

It will obviously de-lever your ACNR because it's running at a very high ACNR percentage, is not at payback yet. And so by deciding top-down, again, there are some channels we're really excited about. So what we did is that's still a nice good amount of money to spend, but it's defined to make sure it doesn't grow to be too high a percentage I think by doing a top down. And that has also driven benefit in ACNR.

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So, ACNR, we've been able to make more efficient without hurting our ability to strategically use advertising to grow. And then remember, this is all with the headwind of the free-paid mix, which we talked about on prior calls, which is the easiest way to think about this is the category is currently out of favor, right? We talked about the category being down 20% year-over-year. Well, the category, it's a discretionary category, and its interest will ebb and flow with the kind of broader economy.

And then frankly, it has a bigger ebb and flow when you think about the COVID sort of boom at the very beginning of COVID, and then the kind of boom that followed it and the thing that people had a bust in which was travel, entertainment, restaurant spend, both of these boom-bust cycles will normalize out. They typically are more correlated to each other around the economy.

And as it does, that free-paid mix have turned into being a tailwind because people are just naturally more interested in the category. The easiest illustrative example is if travel is in a boom cycle and homes not, if you get an e-mail from Booking.com and an e-mail from Wayfair, which one are you more likely to click on? Simply put.

And that's kind of like that free-paid mix. So, that's still a headwind. So, that's kind of – the ad costs gotten much more efficient due to what I described about the three buckets, and that's despite the headwind.

Anna Andreeva
Analyst, Needham & Co. LLC
Q

Okay, that's really helpful. Appreciate it guys and 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

Thanks, Anna. I think we just have time for one more question.

Operator: And our last question comes from the line of Curtis Nagle from BofA. Your line is open.

Curtis Nagle
Analyst, BofA Securities, Inc.
Q

Great. Thanks so much. I guess two quick ones. Just, one, how to think about, I guess, the inventory flow in the industry coming through the rest of the year. It seems like that's been a nice tailwind for you guys. Do you think that continues maybe as surpluses clean up a little bit?

And then just any commentary in terms of, I guess, the latest thinking on addressing the 2025 converts and kind of what's the strategy around that? Thanks.

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

Yes. Great. Let me answer the first part about inventory flow and then maybe I'll turn it over to Kate to answer the second question about the convert. So, on the inventory flow, since last spring, suppliers have had excess inventory. And that, depending on the supplier and how aggressive they were on it and where they started from,

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some have worked their way through it, some are still working their way through it. Some believe they still will take them into early next year to work their way through it.

I'd be cautionary around thinking of that as a temporary sort of tailwind or temporary help. The way to think about it is actually the way the business model works is our model works very well, whether there's kind of an appropriate amount of inventory or an excess amount of inventory. Because what it does is it basically allows the suppliers to lean in and compete against one another to put value in front of the customer.

The excess inventory actually is a bit of a challenge right now because it came in at such a high cost basis. Suppliers are not in a great position to necessarily be as aggressive as they would like to be. And as it normalizes, they then bring goods in that are at a more normal level. Actually, the wholesale costs and therefore, the retail costs will continue to decline as it normalizes out, not increase.

And so that's kind of a nuance based on the dynamic of what happened a year ago. But it's an important one to appreciate because as we get farther into this cycle, we believe that our competitive position actually gets advantaged more, not disadvantaged.

Kate S. Gulliver

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

A

Just to touch on your question around the capital structure. So, you're referencing the 2025. I'd just remind everyone that's a late 2025 maturity. And we believe we have multiple options at our disposal for how to manage this going forward, and we'll continue to be opportunistic there.

So, I'd point you to our September transaction, which is a liability management transaction. We pushed out some of the 2024 and 2025. Maturities is the kind of thing that we might do going forward. And I think that's a good example of how we look at it.

Curtis Nagle

Analyst, BofA Securities, Inc.

Q

Okay. Thank you.

Kate S. Gulliver

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

Great. With that, thank you, everyone, for joining.

Niraj S. Shah

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

Thank you, everybody. Talk to you next quarter.

Operator: That does conclude our conference for today. Thank you for participating. You may now all disconnect.

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