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CONTENTS

CALL PARTICIPANTS 2

PRESENTATION 2

QUESTION AND ANSWER 10

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Presentation

Operator

Good morning. My name is Carol, and I will be your conference operator today. At this time, I would like to welcome everyone to the Wayfair Q3 2016 Earnings Release and Conference Call. [Operator Instructions] At this time, I would like to introduce Michael Fleisher, Chief Financial Officer at Wayfair.

Michael D. Fleisher
Chief Financial Officer

Good morning, and thank you for joining us on election day. We hope everyone has the opportunity to get out and cast their vote. Today, we will review our third quarter 2016 results. With me are Niraj Shah, Co-Founder, Chief Executive Officer and Co-Chairman; and Steve Conine, Co-Founder and Co-Chairman. We will all be available for Q&A following today's prepared remarks. Julia is out on maternity leave with her new daughter Wynn [ph] and will be back with us for year-end.

I would like to remind you that we will make forward-looking statements during this call regarding future events and financial performance, including guidance for the fourth quarter of 2016. We cannot guarantee that any forward-looking statements will be accurate, although we believe that we have been reasonable in our expectations and assumptions. Our 10-K for 2015 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 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. These non-GAAP financial measures could 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, which contains 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. Now I'd like to turn the call over to Niraj.

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

Thanks, Michael, and thank you all for joining us this morning. We are pleased to report another great quarter and update you on some of the exciting initiatives we have underway.

We generated net revenue of $862 million in Q3, up 45% year-over-year, and $832 million in our Direct Retail business, up 53% year-over-year. This represents Direct Retail dollar growth of $287 million versus Q3 2015.

As we have noted in the past, we believe that we are taking 1/3 to 40% of the U.S. online dollar growth in our categories. There is a secular shift underway as consumers shift home purchases away from brick-and-mortar stores and towards online. We believe the strength of our offering, including vast product selection, inspiring visual merchandising, helpful customer service and fast shipping and delivery has positioned us as a beneficiary of that trend, and allows us to take such a significant share of the dollars as they move online.

I want to start this morning by updating everyone on our 3 main investment areas: first, building our international business; second, operationalizing our logistics networks; and third, continuing to fully penetrate our TAM through our

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merchandising efforts in key areas. On this, I'll later review 2 illustrative examples, registry and seasonal décor. These key areas, in which we are investing, have not changed. As we mentioned last quarter, we are focused on these initiatives as they are the right investments to drive the long-term growth and profitability of Wayfair. Our market opportunity is very large, more than $500 billion across North America and Europe. While these investments weigh on our earnings today, we believe they will lead to continued sizable long-term revenue gains and significant levels of sustained profitability in the future.

First, our most substantial investment by far is building out our international business, where we have over 680 people hard at work outside the United States. The international direct business grew over 200% year-over-year, accelerating over last quarter's growth rate. We are currently investing in Canada, the U.K. and Germany, with all 3 at different stages of their development. Canada, which has the benefit of initially leveraging the U.S. catalog and logistics infrastructure, is the farthest along, and we continue to see very strong growth from this clearly underserved market. Our U.K. business is really starting to find its footing with a strengthening product catalog, enhanced delivery capabilities and a good return on ad spend, though we are still in the early days. In Germany, as we mentioned before, is earlier in its development cycle, but the product selection and response from customers is showing great progress and beginning to drive meaningful growth. The aided awareness of our international business on a country-by-country basis is now showing a similar trajectory to the U.S. as we're successfully implementing our U.S. advertising playbook, modified for the nuances of each market. All in all, I could not be more happy with the performance of the international investments. At the same time, it's worth noting that they are, and will remain for some time, a drag on our gross margin, ad spend leverage and adjusted EBITDA. Even with this drag, we maintained our expected gross margin levels at 23.4% and delivered year-over-year leverage in ad spend. This leverage shows the continued strength of the underlying economic model of our U.S. business and its strong and growing base of repeating customers.

The second investment area is our warehousing, logistics and transportation buildout that I discussed extensively on our last quarterly call. All the pieces of our network are coming online as planned. Today, we have approximately 5 million square feet across our logistics footprint with additional facilities opening in early 2017. These facilities are the backbone of our CastleGate service and of our large parcel transportation network. The most important benefits of these investments are a faster delivery promise, lower damage and a higher level of service to our customers. We know this drives customer purchase decisions, higher NPS scores, repeat behavior and, in turn, higher customer lifetime value. As the network comes online, there are short-term incremental costs that weigh on our P&L in both gross margin and OpEx, primarily as we ramp facilities from empty to full. That said, there are strong financial benefits over the long run as our network scales and reaches full utilization.

CastleGate continues its rapid ramp as we onboard more suppliers and get more of their product into our warehouse systems. Currently, approximately 10% of our U.S. business is promised to and deliver to the customer either with a next-day or 2-day delivery promise. As we put our CastleGate facilities online, and as our suppliers fill them with their inventory, we expect that the percent of our business with the next-day or 2-day promise will ramp very quickly.

Our large parcel delivery network also continues its rollout. We are operating 6-metro-area last-mile-delivery operations today and have a planned rollout throughout 2017 of additional cities. With today's footprint, our operation's already ramping to deliver approximately 20% of our large parcel in home deliveries. It's worth noting that in our category, with large bulky goods, it is prone to damage even when delivered by one of the national white glove networks. Our cross-country line-haul network and last-mile-delivery operations will positively impact this as we use our scale to take captive control of a major customer pain point. As with everything we do, there is a substantial investment in building the technology that powers these operations, whether that is the ability to schedule delivery date and time in the cart or the real-time information available to our drivers and dispatchers, and soon our customers, as they make deliveries on the daily routes.

As a reminder, after product cost, we have 3 cost lines that are roughly of equal proportion today: advertising, operational expenses and transportation. Transportation expense is the only cost that can be optimized and lowered on a per-order basis while benefiting all participants in the value chain, Wayfair, our suppliers and, most importantly, our customers. You see faster, higher-quality delivery.

The third major investment area is our merchandising efforts to further penetrate key segments of our addressable

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market. A couple of examples of the many merchandising efforts we have underway are registry and seasonal décor. Registry is part of a larger rollout of enhanced assortment and merchandising in a number of areas where we've historically sold product, but have been underweight versus the size of the category. One of these areas is housewares, which is, in many ways, foundational to the registry business. We recently launched our registry service after a substantial investment period to build the product offering, the selection and the marketing. Registry is approximately a $5 billion market opportunity and serves the customer who's typically just entering the prime age and life stage demographic in our category. People start putting a disproportionate amount of their income towards their home when they enter their early to mid-30s, get married, buy a house and have children. There's a massive wave of millennials who are just beginning to enter this age range, and who are clearly more predisposed to buying online and on mobile. Building affinity with millennials early by being part of their big day is a huge opportunity for us over the next several years.

The registry were also introduced to all of registry couples, wedding guests as a place to shop for their homes. There's a seasonal pattern to wedding registries, and we don't expect meaningful revenue from this new product until we cycle through the summer wedding season in 2017. But we're off to a good, very early start with some 12,000 registries already created since we launched in September.

Another category we built up over the last year is seasonal décor. Last year, we increased our holiday promotions in seasonal décor to take advantage of the fact that the holidays are a great time to attract new customers and invite purchases from repeat customers. In Q4 of this year, we are offering twice as many holiday events with more than twice as many featured items as last year. This year our holiday programs will benefit from the ramp of our CastleGate program. 45% of our holiday seasonal décor items are positioned in our CastleGate warehouses compared to just 3% of our holiday seasonal décor in Q4 of last year. These products are able to reach the vast majority of our customers next-day or 2-day.

This year, we're also offering special seasonal promotions, like 5 ornaments for $25 with free shipping. This program would not have been possible without CastleGate. We are warehousing hundreds of styles of ornaments in our CastleGate facilities around the country. This allows us to save money on the shipping costs and offer the customer a terrific deal on ornaments that can arrive next-day or 2-day.

If you really want to get a sense of the breadth of our holiday offerings, I'd urge you to check out our site, as there are so much there, and it's changing every day. There, you'll see our new holiday style shops, allowing customers to shop for the holiday by style; our new mobile holiday rollout and a much greater use of video and animation throughout the holiday merchandising.

As you can see from these updates, we are making great progress on building the international business, rolling out our logistics capabilities and enhancing our merchandising in key areas. Now I'll turn the call over to Steve, who will provide some background on the technology underpinning some of our recent initiatives.

Steven K. Conine
Co-Founder and Co-Chairman

Thanks, Niraj. As you can tell from the rundown that Niraj just went through, there are so many exciting areas where we are enhancing the customer experience, all built on our technology expertise and the incredible inventiveness of our more than 1,000 engineers and data scientists. I'll use this time to try and highlight just a couple of examples of the key investment areas Niraj mentioned.

We have now fully launched our new wedding registry. Our registry provides features we think are most important for couples today. As an example, we provide group gifting to our customers. Many couples today already own the basic items most registries offer, but have not invested in larger ticket items. Group gifting allows couples to feel comfortable registering for more expensive items like furniture and décor that they really need, and wedding guests are able to contribute whatever amount they feel comfortable as a gift.

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Our registry couples have the ability to seamlessly track progress of their group gift through the Wayfair app, desktop or mobile web experience. And they receive an e-mail notification once a group gift has been completed. If a group gift has not completed, the couple has the ability to apply the credit to another item or completely gift themselves. We believe our registry appeals to millennials who are accustomed to shopping online and increasingly on their phones. Our team is constantly innovating and experimenting with new features, and we expect our registry experience to continuously improve the same way our sites always have. Though group gifting is more blocking and tackling and not some buying [ph] new technology, like our recent innovations in JavaScript single-page applications, or augmented reality, it is a nice example of our team working to understand how our customer lives and shops for her home and building products to make her experience better. Sometimes, things we build are so obvious once completed, you can't understand why it didn't exist in the first place. This is a great example of the benefit of building all your own technology and not using off-the-shelf package software.

I also wanted to provide an update on our 3D image rendering. As I mentioned on past calls, the near-term benefit of our 3D imaging technology is to create inspiring visual imagery without the expensive product samples and physical photo studio buildouts. Our ability to deliver great visual imagery at a low cost allows us to provide an experience that has not previously existed for our customer. For example, with our holiday events, we feature seasonal items in outdoor settings. Two examples of rendered photos are featured on Page 14 in our Investor Relations presentation. These photos were created from 3D models of our outdoor furniture and holiday seasonal items. Once modeled, as seasons change, we can easily swap in appropriate décor. We know this type of imagery can help inspire our customer to make a purchase.

Before 3D rendering, season-specific photography at meaningful scale would have been a prohibitively expensive proposition. With 3D rendering, we can cost-effectively bring seasonal inspiration to life for our customers throughout our sites. Today, we have thousands of 3D-rendered images on our site. This will continue to grow as our 3D model collection ramps up. As we continue to grow the number of private label-branded items we offer, great imagery is particularly important. Our customers rely on photography associated with a brand to find styles and products that suit their aesthetic. We are excited that 3D rendering helps us create the imagery our customer wants while keeping costs down, so that we can still offer great value.

Over time, we will expand our library of 3D models. In addition to using them to create imagery, there are many other exciting future uses. We have already developed an app for use of a Tango-enabled smartphone, which leverages our 3D models so customers can see a live rendering of the product in their home while looking at the screen. A customer can see how a lighting fixture looks hanging over their dining room table or a couch fits in with their current living room furniture and décor. This technology allows the online shopping experience to overcome a common customer challenge of shopping in a brick-and-mortar store. Though the product looks great in the showroom, how will it look in their home? There's a video on our IR website that demonstrates this experience. We look forward to bringing this better shopping experience to a broader range of customers as 3D visualization technology becomes commonplace across the mass market through smartphones and other devices. As a company, we want to make it easier for our customers to shop for her home from her home. We believe 3D models and related technologies will be an important part of this.

Now I'll turn the call back over to Niraj.

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

Thanks, Steve. Before I turn the call over to Michael, I want to touch on 2 other exciting initiatives, the growth of our private-label brands and our new TV show, The Way Home. Today, we have more than 40 private-label brands on our sites, encompassing a variety of styles and price points. One of the biggest challenges in our industry is helping the customer find what they are looking for, that special item for their home. Customers often don't know what they are looking for until they see it. And home is largely an unbranded category, which makes it even more challenging for a customer to articulate what she's looking for. Our private-label brand strategy is one initiative to help customers find the products they want. When a customer finds a product in a style and price point she likes, she can use the private-label brand and the inspiring visual imagery on our site to explore other products of a similar design and price point. Key to our success here is our deep and long-term relationships with our suppliers and our ability to use our data and information about our customers to efficiently build private-label brands that fit what our customer is shopping for.

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For example, Langley Street, one of our private-label brands, offers a moderate price point in a mid-century modern aesthetic across close to 1,000 SKUs. If you go to wayfair.com and search for Langley Street, you'll see how it all comes together for the customer, understanding her style and price point, brought to life with inspiring imagery while providing deep selection and fast delivery.

Other great examples include Breakwater Bay, Lark Manor and Mercury Row. We don't expect our customers to limit themselves to only one of our brands, but it gives them an opportunity to browse a curated view of our vast selection and find what they want.

About a year ago, I mentioned that these private-label brands were a very small, but quickly growing part of Wayfair's business. I want to now update you. Revenue from private-label brands now represent 1/3 of all wayfair.com revenue. We are excited to see the great customer and supplier response to this way of merchandising, and we will continue to build and refine how we bring products to life for our customers and make it easier for her to find what she wants.

Consistent with our inventory-light model, Wayfair does not design the private-label brand products, nor do we take inventory. We work with our suppliers and our vast amount of customer data to identify which of their newly launching products fit into our brands based on the style and price point. We then curate these into collections using inspiring visual imagery.

Now on the marketing side, we continue to implement new and creative ways to introduce customers to Wayfair. You may be familiar with our successful Scripps Network collaboration, where we are an integrated partner in shows like HGTV's Brother vs. Brother and Food Network's Giada Entertains to feature our brand and products. We recently launched a new show series with A&E Networks on the lifetime cable channel called The Way Home. The Way Home is an original concept that's been built from the ground up in partnership with A&E. The most important aspect of the show is that every item in every segment is shoppable at wayfair.com, not just specific items or products that get discussed, but every item can be searched and purchased from us. Working together, we've created a show with great hosts; engaging content, like the many tips we bring to life on our sites; and real life, real customer opportunities for her to make her home unique.

We have a special section of our website dedicated to The Way Home that I encourage you to visit, where you can see all the products featured throughout the episodes, combined with style inspiration and clips from the show. You can find it by searching The Way Home on wayfair.com. Our first episode premiered mid-October, and there'll be a total of 10 one-hour episodes that will be aired multiple times each week through Q4 and into Q1 a we test them across a variety of media schedules and channels. New initiatives like The Way Home are an important component of the large investment we continue to make in building our brand awareness, which today sits at 75%.

Now I'll turn the call over to Michael.

Michael D. Fleisher
Chief Financial Officer

Thanks, Niraj, and good morning, everyone. As always, I will highlight some of the key financial information for the third quarter with more detailed information available in our earnings release and in an updated set of charts in our investor presentation, which can be found on our IR website.

In Q3, our total net revenue increased 45% year-over-year to $861.5 million. As in recent quarters, this growth was driven by our Direct Retail business, which increased 52.7% over Q3 2015 to $832.4 million. Our other business, which primarily includes revenue from our retail partners, but also includes revenue from our small media business, decreased, as expected, 40.6% year-over-year to $29.1 million as we continue to ramp down our retail partner business.

As Niraj mentioned, this quarter, the Direct Retail business increased $287 million versus Q3 last year. We are pleased

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to have maintain this strong momentum even as we reach a larger scale and increasingly comp off a larger base of revenue. As a reminder, the Direct Retail quarterly revenue comps in 2015 increased from 63% in Q1 to 91% in Q3 and then to 98% in Q4.

In Q3 2016, our earlier stage international business in Europe and Canada also exhibited strong growth. Though still relatively small, international direct revenue increased 224% versus Q3 2015, excluding the impact of other revenue from our international retail partners and the impact of our Australian business that we divested last year. Our total net revenue growth remains incredibly high on a dollar basis, and we have been able to continue delivering this growth while maintaining compelling underlying unit economics. We have consistently held gross margin in or above the mid-23s since we went public, and the third quarter of 2016 represents the seventh quarter in a row where we have demonstrated year-over-year ad spend leverage despite the funding of substantial new advertising investment in our international business.

The remaining financials I'll share on a non-GAAP basis, excluding the impact of equity-based compensation and related taxes, which totaled $15.3 million in Q3 2016. For a reconciliation of GAAP to non-GAAP reporting, please refer to our earnings release on our Investor Relations website.

Our gross profit for the quarter, which is net of all product costs, delivery and fulfillment expenses was $201.9 million or 23.4% of total net revenue and was in line with our near-term target margin in the mid-23s.

Customer service and merchant fees were 3.9% of net revenue for the quarter. Though there will be some quarterly fluctuations, we generally expect this expense to be variable.

Advertising spend was $101.3 million in the quarter or 11.8% of net revenue compared to 11.9% in Q3 last year. This represents year-over-year ad spend leverage of 10 basis points in the quarter due to our U.S. ad spend leverage, partially offset by our expected international ad spend ramp. Ad spend efficiencies are driven by our increasing mix of orders from repeat customers, which was 57% of total orders this quarter, because we spend less on advertising to get our existing customers to buy again than to acquire a new customer. The pace of our year-over-year ad spend leverage moderated in 2016 when compared to the pace of the ad spend leverage in 2015 because ad spend leverage in the U.S. is being partially offset by increasing advertising investments in Europe and Canada to fuel new customer acquisition. We expect the fourth quarter of 2016 to show little to no total ad spend leverage year-over-year as we continue to invest in our international markets.

We added approximately 700,000 net new active customers this quarter, bringing the LTM total active customer count to 7.4 million customers, up 60% year-over-year. LTM net revenue per active customer increased to $406, up 9.4% year-over-year. We also saw continued strong repeat purchase behavior, with 57% of orders coming from repeat customers and LTM orders per active customer at 1.69, unchanged from 1.69 a year ago. Absent the mixed impact of the international business, which runs at a lower repeat rate, LTM orders per active customer were up slightly year-over-year.

Our merchandising, marketing and sales spend on a non-GAAP basis was $42 million or 4.9% of net revenue compared to $23.7 million or 4% of net revenue in Q3 2015.

Non-GAAP operations technology and G&A expense was $71.6 million for the quarter or 8.3% of net revenue compared to $36.9 million or 6.2% of net revenue in Q3 last year.

These 2 expense items consist primarily of headcount expenses and their increase reflects the accelerated pace of hiring we had in 2015 and the first half of 2016 to keep up with revenue growth and to invest in the new initiatives Niraj and Steve discussed earlier.

In the third quarter, we added 212 net new employees for a total of 5,610 employees as of September 30, 2016, up 73%

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versus last year. Of the 5,610 employees, we now have approximately 680 of them or 12% are located in Europe. The majority of the compensation expense for the new hires during 2016 resides in the merchandising, marketing and sales and operations technology and G&A expense lines. As we noted on prior calls, the accelerated hiring we saw in the first half of 2016 was a catch-up period as our recruiting team ramped. We believe we are now well staffed for our strategic initiatives and expect to continue to hire at a slower pace during Q4 and into early 2017.

Adjusted EBITDA for the quarter was negative $30.8 million or negative 3.6% of net revenue compared to our guidance of negative 4.25% to negative 4.75% and compared to negative $1.4 million or negative 0.2% of net revenue in the same quarter a year ago. The increase in our adjusted EBITDA loss margin versus Q3 last year was driven primarily by increased operating expenses as a result of the hiring in the U.S. and Europe I just described, and to a lesser extent, by unutilized facilities costs as we ramp up our logistics infrastructure.

As I noted before, the unit economics of our business continued to remain strong with solid gross margin, year-over-year ad spend leverage, increasing mix of orders from repeat customers and increasing revenue per active customer in the third quarter, even as we grew the active customer count to 7.4 million and continue to demonstrate extraordinarily high top line growth. These strong underlying unit economics enable investments in several key strategic areas of our business, which initially drag on gross margin, deleverage ad spend, and in particular, increase operating expenses. As expected, these investments are driving our overall adjusted EBITDA loss and are being offset by the continued success and contribution of the underlying U.S. business. We will continue to monitor all of these investments as we always do, to ensure that we are seeing the proper ROI and customer response.

Non-GAAP free cash flow for the quarter was negative $14 million based on net cash from operating activities of $15.6 million, less capital expenditures of $29.6 million. As expected, CapEx spending was 3.4% of net revenue this quarter, driven by ongoing investments in our data centers and technology infrastructure and equipment purchases and improvements for leased warehouses within our expanding logistics network. We continue to expect full year 2016 CapEx to be approximately 4% of net revenue.

Our inventory level was $19.2 million or 0.6% of LTM sales compared to 0.6% last quarter.

Non-GAAP diluted net loss per share was negative $0.54 and negative $0.72 on a GAAP basis on 85.1 million weighted average common shares outstanding.

As of September 30, 2016, we had approximately $334.5 million of cash, cash equivalents and short- and long-term investments.

Now let me discuss our guidance for the fourth quarter. As I mentioned earlier, we are comping off extraordinarily high Direct Retail growth from Q4 last year of 98%, and Q4 always has a later-in-the-quarter weighting [ph] because of the holidays. We're also extremely cognizant that almost every other company in the consumer retail world has discussed a softening of the consumer spending environment, particularly in discretionary spending and in the mass market. With our high levels of growth, it's difficult to discern what impact this is having on our business as there remains a systemic movement from brick-and-mortar to online. In Q3, though our AOV grew year-over-year, it did decline slightly sequentially, and this is generally across all categories. This could be the normal fluctuations of AOV, as it is an output, rather than an input in the way we manage our business, or it could be a modest impact that we are seeing on the same consumer pullback that others have reported. All of that said, it is always my goal to create guidance that is thoughtful and prudent and to be transparent in our thinking, though this backdrop this quarter makes that a more difficult task and creates our mindset of conservativism in our guide.

For Q4, we are forecasting direct revenue between $890 million to $925 million, which represents a growth rate of 30% to 35%. As I have done in the past, to provide transparency, please note that our quarter-to-date Direct Retail growth is currently comping close to 40%.

We forecast other revenue to be between $30 million to $35 million, down 45% to 35% year-over-year, as we continue

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to deemphasize the retail partner portion of that business, for total net revenue of $920 million to $960 million.

As we said last quarter, we are not going to adjust our current investment spending based on near-term revenue fluctuations or to deliver breakeven in any particular quarter. Because we're guiding revenue at these prudent levels, we will continue to show adjusted EBITDA losses in Q4.

Nothing has changed in both our long-term focus on making the right investment in the business and our desire to drive the business to free cash flow-positive and EBITDA breakeven and profitability in the near to midterm.

We forecast adjusted EBITDA margin of negative 2.75% to negative 3.25% for Q4. Our continued losses at these levels are driven primarily by our ongoing aggressive investment in our international business and the other OpEx headcount and related investments Niraj, Steve and I have described earlier on the call. We are now caught up on our hiring to staff these many initiatives, and that headcount in both our international and U.S. business is a critical investment in the future long-term growth of Wayfair. We have always said that we will make the investments necessary to take advantage of the long-term opportunity created by the significant accelerating shift online in our category. Small movements in our revenue forecast won't [ph] have an outsized impact on our EBITDA margins as we are not rescaling our investments, which are all mid- to longer-term in nature. We do expect to continue showing good unit economics. Remember the Q4, we typically target a slightly lower gross margin rate, between 23% and 23.5%. And as I mentioned earlier, we are anticipating ad spend to run at approximately last year's percent of revenue despite the implicit deleverage created by the ramping in our international business and the leverage we are getting in our U.S. business. Because of our slower pace of hiring and some continued unutilized logistics space, we expect OpEx cost to be only up modestly on a dollar basis sequentially.

For modeling purposes for Q4 2016, please assume equity-based compensation and related tax expense of $18 million, average weighted shares outstanding of 85.5 million and depreciation and amortization of approximately $17.2 million.

Now let me turn the call over to Niraj before we take your questions.

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

Thanks, Michael. Before we take your questions, I want to reiterate how excited I am about how well our business continues to resonate with our customers. We are making many important investments across our business to continue to deliver even higher levels of exceptional service and delight our growing audience of new and repeating Wayfair customers. I'm also proud of the energy, dedication and inventiveness of our team who are singularly focused on delivering on the promise of being all things home for our millions of customers.
Now I'll ask the operator to open up the lines so we can answer a few of your questions. Thank you.

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Question and Answer

Operator

[Operator Instructions] Our first question this morning comes from Neely Tamminga from Piper Jaffray.

Neely J.N. Tamminga
Piper Jaffray Companies, Research Division

Niraj, just wondering if you could flesh out a little bit more on cost around social, what were hearing from a lot of the retailers is that customer acquisition, not necessarily retention but acquisition is hyperbolic right now on social. We know that you guys have been working on this Magellan initiative, so just wondering kind of what you're seeing specifically for your business and how you guys are kind of attacking that component.

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

Sure, Neely. Thanks for your question. What we are seeing, so just to reiterate the way we do customer acquisition, the vast majority of our spend is online, but it's pretty diverse in terms of where it is, in terms of display on the rest of the Internet, native products on social display units on social, what we do on Google's various products including search, and CLAs. And because of that, and also because we are always focused on working on emerging ad units, whether it's a new channel or whether that's developing new ad products with Google or with Facebook or with Pinterest, we generally are pretty well insulated from spikes, because the spikes in pricing tend to be in specific ad units and specific channels at specific times. That said, we referenced Magellan, which is our internal name for our display ad text stack, which we built, we're not buying our own display advertising direct, and we built out a technology like how we conduct our paid search bidding. That I think has helped us significantly in terms of controlling costs, but also, frankly, being able to use all the data we collect and put that to good use in terms of being very surgical. And so long story short, we're not really seeing what you're referencing, which is any sort of real spike in the customer acquisition cost.

Michael D. Fleisher
Chief Financial Officer

And Neely, it's a very high level, but if you run the calculation that we give you all the data create, you'll see that the CAC is actually down this quarter sequentially. And we're sort of well, well within our general target of having a 1 year payback on a contribution margin basis for customer acquisitions. We actually feel really good about the customer acquisition side from a cost perspective.

Neely J.N. Tamminga
Piper Jaffray Companies, Research Division

That's great. And then I just have one follow-up. You guys acquired a little company called Trumpit, I think since you last spoke to us. Could you just give us a sense of what that is and what you intend to do with it in the Wayfair ecosystem?

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

Yes, sure. So Trumpit was a small tech company here in Boston and it's small acquisition from a monetary, very small acquisition from a monetary standpoint. But what we're really excited about was a great team so from a talent perspective, we really invest a lot into our technology, and we have over 1,000 engineers and data scientists on the team today, which is a significant portion of our just under 6,000 people. That give us a very significant competitive advantage. So with the Trumpit acquisition we both get a great team that is able to help in the number of areas. And one of the areas they're actually working on is what their product was focused on which is messaging stack, which we

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believe has some good potential in how we conduct interactions with customers particularly on mobile. So that team is not working on that and some other things internally.

Operator

Our next question today comes from Seth Basham from Wedbush Securities.

Seth Basham
Wedbush Securities Inc., Research Division

My first question is just on the guidance for the fourth quarter. Understanding that you wanted to to give a healthy dose of conservatism, it does appear that you expect a pretty marked deceleration even on a 2-year stack basis. Is there something else besides AOV trends that leads to be more conservative here?

Michael D. Fleisher
Chief Financial Officer

I think the AOV trend is trying to look at that -- well, there's 2 factors here. One is looking at the world at large, right, so we're hard-pressed to find anyone else sort of broadly in the consumer space who hasn't seen some consumer pullback or slowdown and is sort of reporting. That there's a whole bunch of news out just in the last 24 hours about delayed holiday spending. So I think we have sort of that as a backdrop. And the second piece is, as I mentioned on the call, Q4 is back-end loaded, right? I have a bunch of data today that actually feels quite good, right? And as I mentioned, we are running well above our guidance range right now. But with the consumer backdrop, it just seems like we should be thoughtful and conservative in the guide, it doesn't seem there's like a whole lot upside to push it.

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

Just to add a little color on just some things around that, I'll just point out. If you look at the growth in active customers, we're up to just under 7.4 million, that's the number we care a lot about and AOV is a number we care a lot less about, because what we're really focused on is growing the customer relationships with us for the long-term customer value over time rather than the individual transaction value. So we are seeing really great traction there. There's a bunch of metrics that are business, which are leading metrics, which tend to have down the road show up in the financial results. what I'll tell you is we are seeing very, very strong trends in the business, but to Michael's point, when you're guiding and in this quarter, which is definitely weighted ahead of us instead of behind us, obviously, Michael's going to take all that into account.

Seth Basham
Wedbush Securities Inc., Research Division

Got it, that's helpful color. And previously, you had the goal of getting to breakeven in the fourth quarter here. Obviously, it seems like that's unlikely. As you roll the clock forward to 2017, do you think you guys will be profitable on an adjusted EBITDA basis?

Michael D. Fleisher
Chief Financial Officer

Seth, we're going to be very thoughtful than not comment on a specific time frame around breakeven. I think what we said time and again is it is our intention in the near term to get the business to free cash flow positive and EBITDA breakeven, right, and that's a control your own destiny place to be and the place we want to be. I also think that if you -- without too much trouble, if you roll forward a set of reasonable growth rates, and as we've talked about the OpEx leverage now that we are sort of fully staffed and sort of hiring at a slower pace, even with the substantial investment we're making in the international business, right, which is obviously weighing on everything, you'd be hard-pressed not to model out the business to breakeven and profitability in the not-too-distant future.

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Operator

Our next question comes from Matthew Fassler from Goldman Sachs.

Matthew Jermey Fassler
Goldman Sachs Group Inc., Research Division

Just a couple of quick questions. As you think about where you're tracking today relative to your guidance for the quarter, can you talk about how the fourth quarter progressed a year ago as you made your way through it?

Michael D. Fleisher
Chief Financial Officer

You're saying quarter-to-date, Matt, how we progressed?

Matthew Jermey Fassler
Goldman Sachs Group Inc., Research Division

No, just sort of the cadence of the fourth quarter a year ago because you gave us how you're tracking quarter-to-date, just to understand whether the comparisons get notably easier over the course of the quarter, please.

Michael D. Fleisher
Chief Financial Officer

I guess I would say there's a period of harder comparisons and a period of easier comparisons in the forward part of the quarter and [indiscernible] .

Matthew Jermey Fassler
Goldman Sachs Group Inc., Research Division

So that's not material?

Michael D. Fleisher
Chief Financial Officer

No. And it's not -- yes, it's not like the quarter got much harder in the back half last year at all. But the big -- obviously revenue this quarter spikes in a few periods, right? And so you have to -- and that's all ahead of us.

Matthew Jermey Fassler
Goldman Sachs Group Inc., Research Division

Understood. And then a quick follow-up. Your comment on private label penetration reaching 1/3. Can you give us a sense of how that's progressed, what that might be up from a year ago and the extent to which that has helped your gross margins here in 2016.

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

Sure, Matt. This is Niraj. I think the last time we gave an update on that was about 18 months ago, if I remember correctly. And at that time, when we gave that update, we were mentioning that there was something we were pursuing, and we mentioned it was mid-single-digit, so around about 5% of the wayfair.com sales. And we said that it was starting to grow quickly. And then what we said in between is we've kept saying it's growing quickly and now we're saying it's gotten up to 33%, right, up from that 5%, so it's taken significant share of the total. We think there's still a lot of potential

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out ahead of us. To your point on gross margin, I would say that it's certainly an exercise that helps gross margin. We use a lot of technology though to figure out where we take price and where we don't take price. And we do that not just by surveying competitors for similar items, but also testing the price elasticity of items and then how, given the size of our catalog, we move demand between items through substitution based and how we price them relative to each other. And so we are not running it like a linear margin exercise, okay, well, we have this site private label add x amount to margin. We don't we need to it like that. It's much more scientific.

Operator

Our next question comes from Oliver Wintermantel from Evercore ISI.

Oliver Wintermantel
Evercore ISI, Research Division

It would be helpful if you could maybe break down that EBITDA loss of about $31 million this quarter in North America or U.S. versus international, how much of that was contributed by international?

Michael D. Fleisher
Chief Financial Officer

Oli, think if you use the metrics we sort of talked about in the past, you get to a place where you could calculate out the vast, vast majority of that. Probably $25 million plus of that is from the international business, and again that's taking it at a high level sort of. What the ad spend looks like is we sort of detailed ad spend out there. And the bad business runs at a lower gross margin, higher ad spend and a much lower repeat rate as it ramps.

Oliver Wintermantel
Evercore ISI, Research Division

Okay, great. And then in your guidance, maybe it will be helpful if you could, because the last few quarters, I think that breakeven EBITDA was always on the horizon for the end of the year. If you could maybe give us some details about what sales level you think you would have to reach in the fourth quarter to get closer to that breakeven from the guidance -- guided range.

Michael D. Fleisher
Chief Financial Officer

Yes, I think, Oli, we talked about it last quarter. What we said explicitly was that whether we could deliver breakeven in Q4 was highly dependent on what the revenue is going to look like in Q4, because the expense base was basically fixed at this point, right, investments we're making across our logistics network, our international business, et cetera, are basically built into our cost structure. And that we weren't going to change those just to sort of force breakeven in a particular quarter. And I think last quarter, as we talked about it, we said you'd have to be at sort of the very high-end of the 2-year stack, we're obviously guiding lower than the low end of the 2-year stack at this point to be conservative, but I don't think that's still far off from what you'd have to believe to sort of push through enough incremental EBITDA to breakeven. But again, I want to be clear, we are -- we built investments into the business that we need to build because we think there's a huge opportunity there and at the same time, we are extraordinarily bullish about the forward indicators, what's happening in the business today, where the business is at quarter to date, the holiday, we couldn't feel better about Q4 right now. I think we need to be thoughtful sitting here on November 8.

Oliver Wintermantel
Evercore ISI, Research Division

So is it fair to assume that your gross margin level is slightly down to at the same level that we've seen in the first, second and third quarter and the total level and then the rest is more SG&A deleverage?

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Michael D. Fleisher
Chief Financial Officer

I think, as I mentioned in the guidance part of the prepared comments, we typically target a lower gross margin in Q4. So I suggested 23% to 23.5% is the range there. Just because you don't know how sharply you're going to need to reprice [ph] in the back half of the quarter. And obviously, we you don't need to do that, we won't. We'll take the gross margin. And then I think the place where you're going to really start to see leverage in the business, both in Q4 and particularly as we roll into '17, will be in the OpEx line, because as you saw this quarter, we added only 212 net new people. A big chunk of those are actually in the variable cost line, so very little incremental headcount in the OpEx line now that we've got all the people in place we need to be building out the international business, the logistics infrastructure and all the investment areas we're investing in.

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

This is Niraj, it's kind of related. If you look, just -- we went public basically 2 years ago. If you just look at this Q3 over 2 years ago, you'll see what's changed in that two-year period, well, the business has tripled, the direct business has tripled in that period, okay? And if you look at the cycle, you see growth from the time we went public, it basically decelerated, then it accelerated and it decelerated, right, it's doing it in big numbers. So there's an element to which we're growing the business with underlying unit economics and KPIs that are incredibly strong, but we're growing at a very fast rate. We have a mixed shift going on underway with regards to international coming into the total, which is a set of numbers that average you down in a bunch of places but have underlying KPIs that are quite strong and particularly when you project out into the future, you see some really exciting things. And a lot of the areas where we're penetrating the total addressable market, some of these new categories we have been underserved in our starting to really start to grow nicely, but they also average down some of these number. So one of the things that we talked about, starting with next year, we should probably do us a fresh set of material talk about the business just now significantly larger than the one we took public 2 years ago that has a lot more going on, but that's very, very exciting for the future because a lot of the KPIs we get to watch every day are superstrong. And I think it makes it hard to model when you're thinking of the same one basically a U.S. single brand business from 2 years ago. But we sort of get that model and gets hard. So we're going to work on how we help you on that in the future.

Operator

Our next question comes from John Blackledge from Cowen and Company.

John Ryan Blackledge
Cowen and Company, LLC, Research Division

Great. The orders growth was better than we thought. Was that in part driven by the CastleGate program and how is CastleGate driving conversion? And then second, recognizing the registry business is seasonal, are you getting any incremental leverage kind of in 4Q versus 3Q? And fundamentally, is the registry business margins higher than kind of the core business at scale?

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

Sure. Let me just touch on the registry real quick and I'll go back to the first half of your question. On the registry, it's hard to tell right now whether the registry business margin higher or not and because one of the big opportunities we have in the registry is that over 60% of the registry share by the data we have today is held by Bed, Bath and beyond, Macy's and Target. We just see a lot of that coming up for grabs us folks are getting married today, they're much more mobile think, they're not decided the brands. They're online shoppers. And so as we build that up over the next couple of years, we'll see exactly what the mix is there, but what's exciting is to get those customers early in our life cycle in front of all their friends and their guests. And honestly, we have a much broader selection, which more fits what they want. because A lot of these folks already have a kitchen set up and they already have a place that they're living together, and so they may be wanted to use the registry for other purposes. And we're seeing greater links attraction with that, but very premature to say what the economics of it are, and ultimately, it's real values, it's much more in strategic nature,

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rather than just the revenue will add, which we think could also be meaningful. To go back to the first part of your question, I think the way to think about CastleGate is, in the quarter, we mentioned that 10%, 10% is still a pretty low amount of the total relative to where we think it can go, but it's now starting to ramp very nicely. And we entered the year very constrained on space. We only had a million square feet of space. Most of these warehouses were occupying were built for just for our use, so they take a year, a year plus to get set up. We now have a few million square feet of warehouse up and running and it's ramping, being filled very quickly. So I think we've got a lot of gains, but they're mainly ahead of us, not behind us. But we're very excited about what we see with customer behavior around it, what we see with customer satisfaction around it. So I think that's actually something that will benefit us really looking forward.

Operator

Our final question today comes from the line of Michael Graham from Canaccord.

Michael Graham
Canaccord Genuity Limited, Research Division

My question goes back a little bit to the order of frequency/AOV discussion. It looks like the orders per customer is was sort of down the last 2 quarters year-over-year. And I'm looking at Slide 19, your cohort analysis where the 2016 cohort are sort of coming in line of the 2015 cohort spend pretty quickly. I'm just wondering like is this a customer free engagement issue? Can you just talk a little bit about what's going on with the customer engagement and getting them to make as many orders as they did last year.

Michael D. Fleisher
Chief Financial Officer

Just so we're clear, on the 1.69 trailing 12-month orders per active customer, that number is also being impacted by the increasing scale of the international business, which obviously, because it's new runs at a markedly lower orders per active customer. So I think if you took that out, you'd see that the U.S. business was basically flat. The degradation in that is being driven by the impact of the international business. It's sort of piece number one. And then I think in terms of the cohort chart, the thing I would remind you is the last data points on these are always the ones with the fewest data in the set, right. We're adding things that only have a few data points in it the cohort few data points in it. And so, they tend to move around the most obviously the 12 month ones are fixed. But the other thing is we've always said we're going to get to a place where as we start to work our way through the 60 million available households in the U.S. as an example, we've always said we were going to get to cohort stack on top of each other, that the incremental cohort is going to look like the one before it, right? We sort of ramped over the last 3 or 4 years to sort of this place. And so from our perspective, the performance of the '16 cohort on top of the '15 cohort is as expected. And it's certainly as we've modeled in our own plans.

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

Great. I think Michael, hopefully that answers your question. I'll just is recap something I just said around, which is just around there's a lot of other indicators we have the. We look at by customer, by brand, by acquisition channel, by period of age of life, what are -- what behaviors are we seeing for new customers, what the 7 day repeat rate, what's a 15-day, 30-day and what I can tell you is we're actually seeing very good leading indicators for the business. So that's why I sort of said next year, things talking about kind of how we refresh the material to give you some better insights because when you average all these things together, sometimes hard to peel them apart. But the business is continuing to actually grow incredibly strongly with very good unit economics and customer behavior. So that's what we're excited about. We think the holiday's set up to be a very good holiday, and we think we're going to enter next year with a lot of momentum. So anyways, thanks, everyone, for joining us today.

OperatorThis concludes today's conference. You may now disconnect.

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