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Wayfair, Inc. (W)

Q4 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Leandra, and I will be your conference operator today. At this time, I would like to welcome everyone to the Wayfair Q4 2017 Earnings Release and 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]

Mr. Joe Wilson, Associate Director of Investor Relations and Strategic Finance at Wayfair, you may begin your conference.

Joseph Patrick Wilson
Associate Director of Strategic Finance & Investor Relations, Wayfair, Inc.

Good morning and thank you for joining us. Today, we will review our fourth quarter 2017 results. With me are Niraj Shah, Co-Founder, Chief Executive Officer, & Co-Chairman; Steve Conine, Co-Founder & Co-Chairman; Michael Fleisher, Chief Financial Officer; and Julia Donnelly, Head of Corporate Finance. We will all be available for Q&A following today's prepared remarks.

I would like to remind you that we will make forward-looking statements during this call regarding future events and financial performance, including guidance for the first quarter of 2018. 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 SEC filings, including our 10-K for 2017, which we expect to file in the near future, 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 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, 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 would like to turn the call over to Niraj.

Niraj S. Shah

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

Thanks, Joe, and thank you all for joining us this morning. Steve and I are excited to be sharing our fourth quarter and full-year 2017 results with you today. We're very proud of what Wayfair has achieved in 2017 and the strength with which we've entered 2018. For the full-year 2017, we generated $4.7 billion of total net revenue. This represents year-over-year dollar growth of $1.3 billion and growth of 40% on 2016.

Our results in Q4 were particularly strong. In Q4, our Direct Retail business increased 48% year-over-year to $1.4 billion. This represents year-over-year Direct Retail dollar growth of $460 million in the quarter, the largest increase in our history, and over $100 million higher than the year-over-year dollar growth in Q3 2017, which, at the time, was also a company record.

We're continuing to win with customers, with the number of active customers at the end of 2017 growing to approximately 11 million. We're also capturing a higher share of our customer spend, with Q4 LTM revenue per active customer growing by approximately 7% year-over-year to a new high of $422.

With the online portion of the home category growing annually at approximately 15% in the U.S. , it's clear that we are not only benefiting from that shift of dollars from stores to online, but also considerably outpacing that shift and taking share. The success we are seeing is a result of many initiatives, with the central driver being our long-term approach to investing in our business.

Over the last 18 months, we've talked a lot about our three main investment areas, building out our International capabilities; developing our proprietary logistics network, and increasing penetration of categories within our total addressable market, where we've historically under-indexed. We've been investing in these areas because of the results they are delivering for our customers and because we are increasingly bullish on the market opportunity that we see ahead of us.

As large shareholders in the business, Steve and I are very focused on ensuring that our business is the number one choice for customers when they shop for their homes. Shoppers vote with their dollars and by taking a long-term approach to giving them the best possible experience, we're being rewarded with continued gains in market share. The level and timing of our investment decisions is not determined by factors such as near-term revenue performance or by year-end results, but purely by what it takes to serve our customer and, when it makes the most sense, to make that specific investment in order to best achieve our long-term ambition.

This focus on our customers and the long-term has served us incredibly well and we'll continue to be at the core of our decision-making and future growth. We are seeing, for example, ongoing success in the spend we are putting behind our advertising activities in the U.S. and internationally, and we'll continue to invest behind the strength going forward.

We're also adding great people to teams across our business, as we seek to make further progress in bringing our customers and online shopping experience [ph] that is at the (00:06:11) forefront of our category. Some of these investments over the past 18 months have begun paying back now, which you can see in our results, and some of the newer investments are not yet yielding revenue.

One example of an initiative that is still in its early days is design services. There's a team of product, engineering, and marketing folks working on building out this program. And while today it's not yet generating revenue, we're very excited about its future potential. We know one of the top reasons our customers decide not to complete a purchase is because they are not confident in their design ability, and they're simply not sure that the item will look great in their home.

In the luxury market, this is solved with interior designers, but for mass market customers, that option is often out of reach. We know through our normal combination of smart and creative use of technology, and leveraging our scale and business processes, we can bring this confidence to our customer, while creating compelling designs for a room or her whole house sourced from the vast Wayfair selection, as well as from other businesses.

This is just one of many examples, but with our ability to execute in an addressable market of approximately $600 billion in the home category in the United States, Canada and Europe, we're excited by the many opportunities that lie ahead.

Today, I wanted to focus my comments on three areas specifically, the holiday period, our international business, and the developments in our logistics infrastructure. The holiday period is a great time for us to engage with shoppers who are new to Wayfair and with those who are returning to us, and we are very pleased to see our overall offering resonate strongly with both groups again this season. As I mentioned on the Q3 call, our approach to promotions is very analytical and we work closely with our suppliers to be able to offer shoppers products we think they will like at exciting price points.

Looking at the Cyber 5 period particularly, our promotion is centered on our core categories, as many shoppers see the period as a great opportunity to get their homes ready for the holidays, with top performing categories including mattresses, sofas, bedding, and rugs. As outlined in our November press release, Direct Retail gross sales, defined as dollars of order intake, increased 53% year-over-year for the five-day peak shopping period of Thanksgiving Day through Cyber Monday.

Notably, Black Friday, which is traditionally viewed as more of a brick-and-mortar shopping day for consumers, was our highest growth day during that Cyber 5-day period. For the broader holiday period, we increased our focus on seasonal decor this year. It was successful in driving customer engagement and sales. Highlights included our Wayfair basics Christmas Tree program, which offered trees in a variety of heights and styles at opening price points, and our 5-for-$25 ornament shop, which continue to be a favorite with customers, where CastleGate enabled quick and affordable delivery.

Now I would like to talk about our international business, which had a strong year, with 2017 international Direct Retail revenue of $568 million, up 114% year-over-year. We're very excited about the investments we are making in Canada, the UK and Germany, and the engagement we are seeing with customers in these regions.

On the Q2 earnings call, I mentioned that our Canadian business was performing very well, and I'm pleased to say that the momentum has continued. As a result of its proximity, the Canadian business has leveraged many aspects of our U.S. business, and we're targeting many of the same growth initiatives in Canada that are driving success here in the U.S. In 2017, we made a series of operational improvements to the business, including expanding our two- and three-day delivery guarantee to more products and regions in Canada, and launching multiple new trucking routes to increase speed and reduce damage for large parcel items.

In Q2 of this year, we expect to open our first CastleGate warehouse in Canada, further reducing shipping costs and duties, and improving delivery speeds, which we know resonate strongly with customers. Earlier this year, Steve, Michael and I met with suppliers at some of the major European trade shows in our category, and it was great to see that the flywheel there is accelerating in a similar way to what it did when we scaled our U.S. business. Suppliers are excited to work with us and our product selection, site merchandising, and fulfillment continue to improve in both the UK and Germany.

These enhancements are driving improved unit economics and unlocking further opportunities to invest in the strength we are seeing. We plan to scale television brand advertising in Germany later this year, as that business continues to perform. As I mentioned on the last earnings call, our first small CastleGate facility in Germany becomes operational this quarter and should further strengthen our offering to customers in Germany and suppliers in the wider region.

The market share gains we have made in our international business in 2017 are very exciting. Building on this momentum in 2018, we will continue to invest in the customer experience, advertising, and our teams there to capture the sizable market opportunity we see in these regions over the long term. As you will hear from Michael, these continued investments will increase our adjusted EBITDA losses internationally, but, as I noted earlier, now is the right time to make this investment. The customers are clearly responding.

In addition to the opening of our CastleGate warehouses in Canada and Germany, we plan to open further warehouses in Texas and New Jersey, enabling suppliers and customers to further benefit from the program as our business scales. At the end of 2017, we had approximately 7.5 million square feet of space in the U.S. and Europe across our CastleGate and WDN facilities.

In 2018, we expect to add approximately 4 million square feet of space across our network. We expect to add approximately 2 million square feet of this space in our CastleGate facilities in the U.S., approximately 1 million square feet to CastleGate internationally, and approximately 1 million square feet to our WDN last-mile delivery facilities, as we continue with the rollout of that program. The proportion of our U.S. small parcel revenue being shipped from the CastleGate network continued to grow in the second half of last year to approximately 19% in Q4, up from approximately 14% in Q2 of 2017 and we will be targeting further growth this year.

Turning to our delivery infrastructure, today we are operating 20 of our own last-mile delivery facilities in the United States, up from 15 at the end of Q3 2017, with the addition of Cleveland, Tampa, Denver, Richmond, and Hartford, giving us coverage of approximately 60% of U.S. large parcel home deliveries. We're delighted with the improvement and customer satisfaction we are seeing in the markets where we have opened WDN last-mile facilities, and we intend to open additional facilities this year.

We're continuing to take greater control of the WDN middle mile of the delivery process, reducing our reliance on third-parties, and enabling us over time to increase delivery speeds, lower damage and costs, and improve customer satisfaction for more and more of our shoppers. Approximately 80% of the United States large parcel orders in December flowed through the Wayfair-controlled middle mile network of consolidation centers, cross docks, and line haul, up from approximately 70% in Q3. These improvements across WDN are enabling us to offer faster and more convenient customer deliveries, with, for example, the average delivery time of a large parcel item in our U.S. business reduced by approximately five days over the course of 2017.

Finally, on logistics, I wanted to tell you about the inbound supply chain services we're in the early stages of offering our suppliers. As I've highlighted in prior earnings calls, taking greater control of the various stages of our supply chain and logistics is a core part of our strategy and our proposition to suppliers. The inbound supply chain and logistics in our category can be costly and complex for our suppliers and as the scale of business has increased, we have become better placed to coordinate that process and create economies of scale that we can share with our suppliers and customers. We've continued to grow the number of full containers received directly to our CastleGate network from factories overseas.

At the end of 2017, over 65% of the inbound volume to our U.S. warehouses was container direct, further reducing costs and complexity for our suppliers. Further upstream, we're piloting new services with suppliers, including freight pickup and drayage. Last year, we also secured an NVOCC license to handle ocean containers on behalf of our suppliers, contracting directly with carriers rather than intermediaries, and last month our first pilot shipment departed from China.

The benefits of this integration are sizable. First, we can take costs out of the supply chain, benefiting suppliers, customers, and Wayfair. Secondly, it will improve our visibility of supply, helping us better plan the utilization of warehouse resources and enabling us to work more effectively with suppliers to optimize inventory replenishment. We can do this by sharing our deep understanding of customer demand with our suppliers, taking a much more strategic approach to inbound product planning than a third-party logistics company.

Finally, we believe that managing elements of the inbound process will appeal strongly to many of our suppliers, enabling them to spend more time on the core functions of their business. This operation is in its early days, but we are excited about its future potential.

I will now turn the call over to Steve.

Steven K. Conine

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

Thanks, Niraj. The holiday period is the busiest time of year for our business, and I wanted to tell you more about how our approach to technology enables us to be prepared for the volume we see in Q4. We are constantly innovating to make the shopping experience as engaging and convenient as possible for our customers.

We have built a wide range of shopping tools on our sites and mobile apps to address the unique challenges of shopping online for home, allowing us to offer an experience that is at the forefront of ecommerce in our category. Features, such as Idea Boards, View in Room 3D and Search with Photo, have enabled our customers to discover products they love on Wayfair and make informed purchase decisions in a way that historically has been challenging when shopping for the home online.

When we launch new features like these, or make smaller changes to our sites, such as user interface changes, promotional events or back-end performance improvements, we do so in such a way that we can track customer responses in real-time and make rapid incremental changes to further optimize the experience. This test-and-learn approach has made it possible for us to constantly improve the experience on Wayfair, while we scale our operations at pace.

By constantly innovating across our site, we benefit from these improvements as early as possible and generate learnings in advance of periods of elevated demand, such as the holidays. During Cyber 5, our in-house ad tech platform sent over 100 million uniquely customized e-mails, directing customers to specific promotions throughout the weekend. Traffic peaked at approximately 1.6 million hits per second to our site, which is more than twice the peak traffic in 2016. We can successfully manage this growth in volume due to the continuous scaling and testing of our systems throughout the year.

Technology plays a key role in ensuring that we can offer customers prompt delivery of their orders, which we know is a key driver of their overall satisfaction, and is particularly important for the holiday period. We have invested considerable resources in the technology that supports our supply chain/logistics. As a result of our product range consisting of items dispatched directly from suppliers and the growing portion being shipped from our CastleGate warehouses, we need a technology solution that optimizes for this hybrid.

The uniqueness of our model, coupled with the low penetration of ecommerce in our category, meant that the logistics software we needed did not exist in the market. We have, therefore, built systems to give customers an accurate estimate of delivery timing when they're considering buying an item from us, and that can scale with the growth in our business. In periods of elevated volume, it is critical that we maintain high visibility of factors that will influence the time taken to deliver and order to our customer's home.

Our technology plays a key role in that visibility and, just as important, is the collaborative approach we take with suppliers, working with them to ensure they provide the inventory data that is central to our planning and making sure that their products are available for our customers to buy. In our business, every day is generally a little bigger than the day before and our goal is, therefore, to treat the larger holiday spikes as business as usual rather than a time to change our behavior dramatically.

Our approach to technology is to build long-term solutions to the complexities in our business, many of which are specific to our category. This approach, coupled with our pace of growth, has enabled us to build a customer offering that is leading the way in ecommerce for the home and that can scale as we continue to increase our market penetration in the U.S. and internationally.

I will now hand the call over to Michael to take you through the financials.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

Thanks, Steve, and good morning, everyone. I will now provide some highlights of the key financial information for the quarter, with more detailed information available in our earnings release and in our investor presentation on our IR site.

In Q4, our Direct Retail business increased 48% year-over-year to $1,419 million, representing year-over-year dollar growth of $460 million, which, as Niraj highlighted earlier, was the largest increase in our history. Our total net revenue increased 46% year-over-year to $1,439 million. Our other business, which primarily includes revenue from our retail partners, but also includes revenue from our small media business, decreased year-over-year, as expected, to $20 million, as we continue to scale down our retail partner business.

Our KPIs, which we report on a consolidated global basis, demonstrated continued strength in Q4, many at all-time highs. In addition to growth in active customers and revenue per active customer that Niraj highlighted earlier, purchase frequency, as measured by LTM orders per active customer, continued the growth we saw throughout 2017, reaching a new high of 1.77 in Q4. Average order value was $229, which was lower than Q3, in line with the seasonal trend of lower ticket holiday items being purchased in Q4. Orders from repeat customers in Q4 grew year-over-year at more than twice the rate of orders from new customers.

Turning now to just our U.S. business, our Direct Retail business increased to $1,228 million in Q4, up 43% year-over-year. This represents year-over-year dollar growth in the quarter of $369 million in U.S. Direct Retail revenue. Direct Retail revenue from our international businesses in Canada, the UK and Germany, collectively increased to $192 million, up 91% versus Q4 last year. Our customer offering in international markets continues to strengthen, and we are very pleased with the market share we're gaining and the momentum we take forward into 2018.

I'll share the remaining financials on a non-GAAP basis, excluding the impact of equity-based compensation and related taxes, which totaled $22 million in Q4 2017. For a reconciliation of GAAP to non-GAAP reporting, please refer to our earnings release on our IR site.

Gross profit for the quarter, which is net of all product costs, delivery and fulfillment expenses, was $333 million, or 23.1% of net revenue, consistent with our near-term expectation for gross margins in the 23% to 24% range. In Q4, advertising spend was $166 million, or 11.5% of net revenue. We are continuing to see great opportunities to invest advertising dollars and generate ROIs within the one-year payback that is central to our approach.

In Q1, we expect higher sequential ad costs as a percentage of revenue, as we generally lean in on advertising early in the calendar year to take advantage of very attractive market pricing. We anticipate ad spend as a percent of net revenue in Q1 to be slightly above or below last year's Q1 at 12.3% of net revenue.

The effectiveness of our advertising spend is central to the success of our business, and I want to briefly touch on our overall approach to investing ad dollars to ensure that it's fully understood. We take a highly analytic approach to how we invest ad dollars, measuring ROI on the spend across channels to achieve an overall payback period of approximately 12 months on a contribution margin basis.

With the majority of our ad dollars spent on digital channels and six years of data on customer behavior under the Wayfair brand, we are able to measure payback on an extremely granular basis.

Our proprietary ad tech stack that we brought in-house over the last four years is also a competitive advantage that allows us to leverage internal and external data to target customers efficiently. The ongoing improvement in the performance of our site has resulted in more and more opportunities for us to invest ad dollars, while staying within the same overall payback period on a contribution margin basis.

To be clear, we are spending more dollars, because we believe we can spend those dollars at the same level of efficiency; not because we are lengthening the payback period or because we are seeing higher pricing in the online ad markets in which we participate. We will continue to invest behind these high ROI activities due to the long-term approach that Niraj highlighted at the start of the call, and we feel good about the customers we are acquiring, who will add incremental value over their lifetime.

Now our non-GAAP merchandising, marketing and sales expense, and operations, technology and G&A expense are driven primarily by compensation costs. The distinction between the two expense categories could often be limited and we believe that the separation has become less meaningful as our business has continued to scale. Starting with this Q4, we combined these two expense groupings to form a single OpEx line called selling, operations, technology, and G&A to provide a more straightforward view of our P&L.

In Q4, these two line items resulted in total OpEx of $161 million. As highlighted in our last call, we continued to ramp-up hiring across our business, which is central to our three main investment areas of building our international capabilities, developing our proprietary logistics network, and increasing penetration of categories in our total addressable market, where we have historically under-indexed.

We added 861 net new employees in the fourth quarter for a total of 7,751 employees as of December 31, 2017. Approximately 520 of these net new employees were in variable cost areas of our business, namely customer service and in our logistics operations, and we expect to continue to build head count in these areas as our business scales.

Approximately 340 of the net new employees in Q4 were in OpEx, areas such as marketing, merchandising, operations and technology, compared with approximately 300 net new employees added in those areas in Q3. We expect to significantly increase our hiring in these OpEx areas in the first half of 2018 and Q1 hiring is at a pace well ahead of Q4's 340. We're excited to be adding great people to our teams across the business.

As we've said in recent earnings calls, with the ongoing build-out of our CastleGate and WDN facilities, unutilized rent is forecast to continue to weigh on our P&L. In 2018, we expect this to be in the $5 million to $8 million range per quarter in OpEx across our global business, now including the impact of the unutilized rent in our international operations as well.

Adjusted EBITDA for the fourth quarter was negative $21 million, or negative 1.5% of net revenue. Adjusted EBITDA for the U.S. business in Q4 was positive $7 million, in line with our expectations for the quarter. In our international business, adjusted EBITDA in Q4 was negative $28 million, which was in line with our expectations, as we continue to invest behind the strength we are seeing in Canada, the UK, and Germany.

Non-GAAP free cash flow for the quarter was $1 million, based on net cash from operating activities of $37 million and capital expenditures of $36 million. Historically, the timing of our sales in Q4 has enabled us to exit the quarter with a higher days payable balance. This year, due to the timing of some larger year-end payments at the end of the quarter, our days payable came in towards the lower end of our historic range.

CapEx spending was 2.5% of net revenue in Q4, resulting in total 2017 CapEx of 3.1% of net revenue. We expect CapEx to run at approximately 4% of net revenue in Q1. We had $642 million of cash, cash equivalents, and short and long-term investments as of December 31, 2017.

Before I turn to guidance, I want to mention two housekeeping points. As I highlighted over the last two quarters, we'll be refreshing our investor presentation materials for our next earnings call and will not provide the cohort slide on a quarterly basis going forward. As you can see from the cohort slide in this quarter's presentation, customer performance has remained highly consistent over long periods of time.

You will also see in our 8-K filing this morning that our board recently authorized up to $200 million of Class A share repurchases, though the actual timing, number, and value of shares repurchased will be at the company's discretion. Based on the current state of market volatility, we believe it's prudent to have this authorization as a tool on the shelf. We intend to only use it opportunistically, if warranted, based on market condition.

Now let me outline our guidance for Q1 2018. We forecast Direct Retail revenue of $1.315 billion to $1.345 billion, a growth rate of approximately 40% to 43% year-over-year and representing year-over-year Direct Retail dollar growth of approximately $400 million. Within that, we expect U.S. Direct Retail year-over-year growth in the range of 34% to 37% and international Direct Retail year-over-year growth in the range of 85% to 95%.

As always, we are prudent when we set revenue guidance. We have an increasing comp versus last year when our business accelerated in the end of the quarter, in part driven by the timing of delayed tax refund payments last year. At our increasing scale, macro factors can impact our results and we are clearly in a period of market volatility that may impact consumer confidence.

To give transparency on current trending, as I've done previously, our Direct Retail gross revenue quarter-to-date has grown above 45% year-over-year, but given the increasing comp towards the end of the quarter that I referenced above, we are guiding to a lower level for the full quarter. Overall, our guidance for Q1 points to another strong quarter of growth on an increasingly large base and we continue to be extremely pleased with the market share we are gaining. We forecast other revenue to be between $13 million and $17 million for total net revenue of approximately $1.33 billion to $1.36 billion for the first quarter.

We are continuing to make the investments that have driven our growth to-date and that we believe will be instrumental to our success over the longer term, both in the U.S. and internationally. As Niraj mentioned, throughout our company's 16-year history, we have always invested in a way that best serves our customers over the long term, and we do not attempt to match spending in a particular quarter with revenue in that quarter.

We are seeing good responses from customers in our international business and we're adding resources and ad spend there that will increase our near-term losses. We are also adding to the team and continuing to make high ROI long-term investments, like our logistics operations in the U.S. business, and as I mentioned earlier, OpEx hiring is running at a much higher pace in Q1.

Combined with the typical seasonal higher ad spend, we anticipate that the U.S. business may come in under breakeven EBITDA in Q1. We continue to expect that the U.S. business, which has been EBITDA profitable for the last five quarters, will remain on that trajectory, though we won't slow or attempt to time our investments to make this happen in any particular quarter.

For consolidated adjusted EBITDA, we forecast margins of negative 3.9% to negative 4.2% for Q1 2018. These losses are primarily driven by our international business, with negative EBITDA in the range of $40 million to $45 million. The U.S. business, with its seasonally-higher ad spend in Q1, continued ramp in OpEx hiring, we expect will come in between breakeven and a negative 1% adjusted EBITDA margin.

For modeling purposes for Q1 2018, please assume equity-based compensation and related tax expense of $24 million to $26 million, average weighted shares outstanding of 88.5 million, and depreciation and amortization of $26 million to $28 million.

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

Niraj S. Shah

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

Thanks, Michael. 2017 was a great year for Wayfair and we're delighted to have started 2018 with strong momentum across our business. This time last year, Steve and I wrote an annual shareholder letter that reflected on the progress of the business and our objectives for the future. This year, when we thought about writing the shareholder letter, we looked at last year's and not surprisingly, the themes remain the same. Our focus remains unchanged, the long-term success of our business rests on our ability to continue and delight and serve our customers, and we take a long-term view in investing in our business to do just that.

Instead of writing another formal letter, Steve and I decided the better way to give investors insight into our thinking would be to share an e-mail that I sent to employees just last month. In it, I highlighted the progress we made in 2017 and the competitive advantages we have built that put us in a great position to keep winning in our category. You could find this e-mail on our Investor website. Steve and I are very proud of what our team of over 7,000 employees is achieving and the response we are seeing from our customers, and we're excited by the opportunity we're capturing in the U.S. and internationally.

With that, I'll now turn the call over to the operator so that we can take some of your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And our first question comes from the line of Peter Keith with Piper Jaffray. Your line is open.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Hi. Thanks. Good morning, everyone. Congrats on a nice revenue quarter. I wanted to just ask a little bit about the profitability, maybe looking specifically at the U.S. segment. So you showed very nice EBITDA margin improvement year-on-year every quarter in the U.S. Q1 to Q3, and then Q4 took a little bit of a step back. I was curious if there's a seasonal aspect to Q4 that may have put a little downward pressure, or if it's more around some of the continued investments that you're making to drive the future growth.

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

A

Hey, Peter. Thanks. It's Niraj. Yeah, so I guess a few thoughts. One, I think, year-over-year, obviously, it matters for certain seasonal trends and things like that. But it also – with the way in which we're growing, the way in which we're – we're certainly trying to take an aggressive posture around being the customers' favorite destination to effectively be the big market share winner. So year-over-year the rate of growth we have doesn't always give you as much insight as sequentially, so you kind of need to look at both. And so what I'd tell you in Q4, one is, gross margin had been coming in a little high prior to that and we've been saying 23% to 24%. Q4 came in in that range. Q4 is typically a little lower than other quarters, but sequentially that's a delta, that would be a piece of it.

The second is, we've talked a lot about these three major investment areas: logistics, the international business, and really fully penetrating the TAM. And so, our focus hasn't changed. The economic return we're seeing from all the things we're doing is actually incredibly high, but we are continuing to build out those teams. And so, from a head count, from an OpEx head count standpoint, that's something else that is ramping. And so, again, you've got to think about that sequentially, because you effectively hire people. They join payroll. The economic return, while very fast, is not immediate, so you got to go out a couple, few quarters for that, so on and so forth. And so we have a period of slower hiring. Then next few quarters have slower benefits, but they have a lower payroll. And then we have a period of higher hiring, payroll starts to increase, but the benefits are out couple, few quarters, whatever way you want to think about it.

So I think that's really the dynamic, more than anything else, and so we don't worry about a particular quarter in and of itself. We don't really worry about the year-over-year compare as much as we worry about sort of the strategy and are we playing for the right long-term win and are we being highly quantitative in how we're doing it, measuring the return, making sure that each dollar we spend is getting the return, that we're being very thoughtful.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay. Thank you. That's helpful, and maybe just to piggyback on that. Not looking at quarter, but looking at a full-year basis, you did show very nice EBITDA margin improvement on a full-year basis of about 100 basis points. I know you don't like to look out too far with guidance, but what would be the puts and takes as we look out to 2018 that could either put pressure on that expansion or perhaps allow further expansion greater than 100 basis points for the full-year?

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

A

Yeah. Let me just share couple thoughts and let Michael comment, because he really discusses the guidance portion. At a high level what I would tell you, what Michael said in the script, in the comments a few minutes ago, was that if you think about when we went public to now, so that's only about three and a half years, we've over tripled in size and the business has changed fairly dramatically. We have a much stronger brand now. We have this asset-based logistics. We have significantly larger team, or a much larger customer base with better repeat economics. So very positive things,.

So, if you'd think about the U.S. going forward – I think Michael made some comments about how we've had five quarters of profitability, and if you look forward over the next X quarters, we don't foresee that really changing. And now in a given quarter it may or may not be profitable, but the trajectory, because of the amount of growth and the fact that we've protected the unit economics, the flow through is sufficiently large that despite having a very growth-oriented posture and being willing to invest into our team and to customer acquisition, despite all that, you effectively get flow through. So that drives the profitability.

So when you look forward, you said – a year is just a collection of four arbitrary quarters. But so year-over-year on a year is still the same kind of argument I would make, but when you look forward I think what you're going to see is that business continues to grow the way we would expect, you're going to have a lot of flow through, and in general you're going to see some of that flow through. That said, we're not afraid to spend money where it makes sense, and we're in the midst of ramping up a bunch of these team's head count, where we're seeing really great returns and there's a lot we want to do.

And one of the questions I sort of anticipate someone may ask later might be about transportation and trucking, because that's become a talk in the retail industry. Well, we're two years into building out asset-based logistics that, frankly, let us take control of transportation costs in a way that our competitors can't. So there's a lot of things we're doing that we're going to continue to drive, and so there's no magic number of basis points we're looking for year-over-year versus the long-term. But, Michael, do you have any specific guidance thoughts?

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

No. The only thing I might add to that is that Niraj mentioned the OpEx side and how we're thinking about the U.S. business in terms of profitability. I might add that on the international business, we continue to see that business gaining traction with customers and because of that, we continue to be more than comfortable making increased investments there. Those investments are coming in the form of people, as well as growing a business that's got a lower gross margin and higher ad costs, and increasing the ad spend in those businesses, as we start to see the flywheel turning with our customers.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay. That's great. Thanks a lot, guys. Good luck with this coming year.

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

A

Thanks, Peter.

Operator: Your next question comes from the line of John Blackledge with Cowen. Your line is open.

John Blackledge
Analyst, Cowen & Co. LLC

Q

Great. Thank you. Just a couple questions. First, maybe for Niraj. How are the investments in fulfillment and logistics driving conversion rates? And you just kind of alluded in your last reply. How do you kind of view the investments in fulfillment and logistics as a competitive advantage over the longer term? And then just a question on international expansion, just wondering if you're contemplating any new markets in 2018. Thank you.

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

A

Thanks, John. Okay. So first, let me talk about the logistics piece. So, the fulfillment and logistics, so we started ramping that about two years ago, so we tested in 2015. We were happy with the results we saw from the customer sort of excitement around fast delivery, the two-day delivery promise, as well as on the large parcel, the WDN, the home delivery experience. And so what we've been sort of doing in 2016 was ramping it. So we have over 7 million square feet of warehouse now. You saw the small parcel numbers approaching 20%. You saw that we have 20 large parcel home delivery operations. That's approaching 60% of the U.S., and you see that continuing to move forward.

I think what might not be as well understood, when we talk about the benefits of logistics, we tend to focus on the customer benefits, and the customer benefits are really important to highlight, because we try to make everything we do logically driven by what customers ideally would like. And then we try to figure out how to achieve it in an economically rational way that works for us and for the customer, and logistics is one which enables a customer to get faster delivery, more convenient delivery, more transparent delivery, so lot of positive things.

But embedded in that are two other big advantages for us, I guess three. One is that it can reduce our transportation cost, because we can make the whole value chain of where our suppliers are making the goods, a lot of which are imported from Asia, all the way to where the customer is getting delivery. We can make that chain much more efficient, and any efficiency results in less moves, less mileage, so on and so forth. So that's a cost saving that we benefit from; our suppliers, our customers benefit from.

The second thing is our goods. We have large classes of goods that are prone to damage, and so in apparel, people talk about returns. Well, in our world, people talk about damage. And so when you can handle the goods yourself and minimize touches, you can significantly affect damage, which is a hidden cost in our business. And we have great customer service. We always take care of a customer if something goes wrong, but frankly, reducing damage is really highly economically attractive and, obviously, very attractive to everyone involved, . So that's the second big benefit.

And the third is the more integrated we get with our suppliers on the flow of goods into our network from their network, the more we can actually make sure that we can stay in stock, prevent out of stocks, keep the inventory turning in a very rational way. Even though we're not taking the balance sheet risk, there's real attractive economics for the supplier the more that they – they see that they can grow their volume and manage the turns and do it in an efficient way. And we now have a warehouse footprint and all kinds of transportation services that basically enable this.

So there's a really high return when you think about these different things. The customer value proposition, though, has not changed in terms of customers who love the fast delivery, so we see significant conversion increases there. We see significant NPS lifts. When we do look-backs, we see significant CLV increases.

So the customers love it, and then we have all these cost and efficiency and quality benefits. And so the competitive advantage comes out of the aggregate of all of those, which is quite large. And we still think there's a lot of nuance we can add to that that's basically putting us in a stronger and stronger position versus our competitors, who are either relying on third-parties for these transportation services or effectively doing it in kind of a fixed way without evolving them, certainly not building a proprietary technology to power things, like the customer Day of Delivery experience and things like that.

Your second just on international, I'll touch on it really quickly. Right now we're really focused on Canada, the UK and Germany, and so right now there's nothing else really to talk about other than they're progressing really nicely, and really each one individually is progressing quite nicely.

John Blackledge
Analyst, Cowen & Co. LLC

Q

Thank you.

Operator: Your next question comes from the line of Seth Basham with Wedbush Securities. Your line is open.

Seth M. Basham
Analyst, Wedbush Securities, Inc.

Q

Thanks a lot, and good morning.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

Hey, Seth.

Seth M. Basham
Analyst, Wedbush Securities, Inc.

Q

My first question is about flow through. Niraj, you talked about being able to get flow through on incremental contribution margin as you grow that base of customers. In the fourth quarter, you beat your revenue guidance handily. The flow through on the incremental revenue upside looked kind of soft. I'm just wondering about your philosophy here. Do you plan on continuing to spend that contribution margin upside, or will we see it drop to bottom line at some point soon?

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

A

Yes. So we don't actually think about it as spending the flow through. We decide what we're going to spend without necessarily deciding what the revenue number is. So in other words, if we're looking at building up a team on an initiative, like I was talking about transportation a few minutes ago. So we're talking about building the inbound ocean freight operation or the drayage operation or what we're going to do in consolidation brokerage or if I talk about the WDN rollout and some new models we want to test there. We decide if we think that's sensible. We find a way to test it, and if it's good and it shows good customer benefits, good economics, we'll scale it up. And we'll do that sort of regardless of what revenue in a given quarter is going to be. So that's just a head count growth.

The advertising – and advertising growth is driven by, again, customer economics around paybacks, and so if a team on the advertising side in the channel figures out a breakthrough that lets us acquire a bunch more customers very economically, they can go do that. We're very excited about that. So those are the cost sides. And then separately, this all should have impacts on customers. Now the customer impacts are not linear day in/day out, one-to-one, so there's lags and different investments and so on and so forth, but then those customer impacts create revenue and repeat revenue. And we make sure that we protect the unit economics, so we get the contribution margin. And then, you add those together, but one is not decided tied to the other. And so, that's why I also say we don't care about a given quarter, because if you start caring about a given quarter, you start making short-term decisions. And you basically find the companies that make short-term decisions are the ones that end up basically losing to those that basically focus on customers and make good long-term decisions. That's what we believe.

Now we're very economically practical and quantitatively prudent, so we're not going to chase growth. But within the confines of these very conservative payback frameworks and very high ROI frameworks, we absolutely will pursue those opportunity.

Seth M. Basham
Analyst, Wedbush Securities, Inc.

Q

Understood. Perhaps another way of ask that question then. Looking at the fourth quarter results, were there specific cost areas that ran higher than you planned when you provided guidance for EBITDA margins for the quarter?

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

So I don't think it's necessary that there were sort of specific areas that ran higher than when we created guidance a quarter ago. The areas I'd point to are, one, we've talked about gross margin for several quarters now as something that we expect to run in that 23% to 24% range. In part, because of what Niraj was talking about earlier, the increased investment we've made over the last couple of years in the logistics build-out. Now that it's built out, we're not yet running that network at efficiency. And so we've always said those costs are going to increase before they come back down to below their baseline level, and we're clearly in that period now and you'll see that in the delivery cost details.

And then, I think the other piece, which I tried to note on the call, is that we are – we have continued to sort of ramp hiring. I think that went well in Q4. It's really ramped up in Q1. And so, when we crafted our guidance for Q1, I think that's a perfect example of an area of, hey, we enter 2018 with a very clear plan of here are all the teams we want to staff [ph] again, which (00:51:00) we think have the highest ROI initiatives, and we've got the recruiting team going after that.

If they can fill those folks faster, sooner, better, we want them to. If that means that I'm going to end up with more OpEx cost in Q1 than I otherwise would have, which pushes the U.S. business, as an example, into an EBITDA negative position for a quarter, we're quite comfortable with that. And then digest those folks and they'll be doing good work and generate the things that generate more customers and more revenue.

Seth M. Basham
Analyst, Wedbush Securities, Inc.

Q

Fair enough. Thank you. And my follow-up question is just around activated customers. The year-over-year growth rate in activated customers slowed in the last two quarters and the number of activated customers actually declined about 17% year-over-year in the fourth quarter by my calculation. Is that a trend that we should expect to see continue? Is that a matter of law of large numbers, or how do you think about growing the customer file going forward?

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

A

Yeah. I mean, at a high level – I'll let Michael comment on some of the derivative analytics driven from our numbers. But at a high level, I'd say we continue to acquire customers at a good pace. The brand recognition we have in the markets we're in continues to grow really nicely. The active customer count being at 11 million growing nicely, and then the behavior of those customers, the repeat, and the repeat spend, we're quite happy with it. I'm not exactly sure what number you see decline. Maybe I'll let Michael comment.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

Yeah. Seth, I noted on the active customer number. I think the way we – you have to think about this and we talked about this over the last several quarters. We now have a very large base of repeating customers. So even though it's a much lower percentage of net revenue, we spend a substantial amount of our ad dollars against repeat customers and trying to unlock the most efficient way to get that customer to come back again and again and again is the, sort of, key focus for the marketing teams.

We continue to go out and spend ad dollars within our one-year payback framework, which I talked about in the prepared remarks and which we've talked about every quarter, and continue to see really good efficient use of that and we're under our one-year paybacks and we'll keep doing that. So I think it is – there's a little bit of law of large numbers. There's a little bit of where we're placing that spend. And then, the other piece that I always note when people look at the specifics of a quarter or a couple quarters is our ad spend, though we talk about it in a way as if it's sort of like happens in a quarter and the customer shows up in the quarter, that's not the way it works in reality.

We're often running ads that are a display ad that gets the customer to click in, that gets the customer to come to the site, but we know that the best customers we can get are top, top, top of the funnel, the folks who are just beginning their search for a product. And so oftentimes, the ad dollars we're spending generate a customer in the next quarter or the next quarter. So I think it's a balance of all those things, but I think we feel extremely good about the customer growth both on the new side and driving incremental purchases for repeat customers.

Seth M. Basham
Analyst, Wedbush Securities, Inc.

Q

Got it. Thank you very much, and good luck.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

Thanks, Seth.

Operator: Your next question comes from the line of Oliver Wintermantel with MoffettNathanson. Your line is open.

Oliver Wintermantel
Analyst, MoffettNathanson LLC

Q

Yeah, thanks. Good morning, guys. I had a question regarding the network build-out. So after you guys build-out, I think you said 4 million square feet this year, can you maybe tell us where you think you are in the build-out? I don't know if you want to put it in innings or where do you think you want to be in the build-out there. Thank you.

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

A

Hi, Ollie. It's Niraj. So, two thoughts there, which I think, hopefully, will help answer your question. So one is a lot of the initial build-out is the ramp from effectively zero of our volume going through our network to X percent of our volume going through our network. And so you have to build the network fairly quickly, because your penetration rises, and so the amount of just growth is significant. And so we've given you different numbers. You have the percentage of home deliveries going through the home delivery network of close to 60%, and the percent going to the middle mile, and you've got the percent of small parcels coming out of the – there's always different penetration numbers.

So on one hand we're waiting for that to continue to grow, but then the second growth is, assuming the penetration doesn't grow, just what's our rate of our business growing. And so just as the business grows at X rate, which last year was 40%, if you didn't add any penetration, but you want to hold penetration, in theory, just linear math, you'd need 40% more space. I mean, [ph] technically would (00:55:37) be exactly true, but you understand the concept. And so, you're going to end up with build-out sort of for that reason alone.

The 4 million square feet on top of the network we have right now is not a huge amount when you factor our growth rate into account, in addition to the fact that we have penetration goals. And the reason that's not a huge amount is that we do have unutilized space right now, which we've talked about. And we have unutilized space, because there is a network footprint we wanted to build-out.

So just having one warehouse and it being full doesn't really allow us to strategically achieve our objectives. So we needed to build-out different locations, which allow us then achieve our objectives, but then you have unutilized space, which we consider fine, we consider that part of the investment. But then as we ramp, we can start to utilize it, which makes the unutilized go down, but then you need to grow the network as you grow penetration, as you grow just your overall growth.

And so you're kind of seeing that number being lower this year. But then if you try to forecast past this year, a lot of it comes down to what amount of penetration growth do you want and what amount of growth do you have in general. And those really drive the number, because you're kind of through the unutilized being a big portion. So I think that's helpful.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

Yes. And, Ollie, I think that – first of all, it's good to have you back. I think the metaphor of sort of what inning is hard. The way I think about it is like that we've built the foundation and the first floor. Now as we grow, we're going to add to it. But building that foundation and first floor, you've got to – that is a very particular footprint and it has to be done a certain way in order to support the future, and so I think we've done that.

So an example might be that we now talked about having a lot of our product coming into CastleGate container direct. That container direct comes into two ports on the coast mostly. So that's the place where you've got increased volume, you're going to add to those boxes, and you're going to need more space there, where we may have put 1 million square foot footprint building somewhere else in the network that isn't yet at full utilization, even though at the ports you're going to need more space. And so it's not a perfect – no metaphor is perfect, but it's not like I built [indiscernible] (00:57:39) one floor, one floor, one floor. There's pieces to it as we build-out. I hope that helps.

Oliver Wintermantel
Analyst, MoffettNathanson LLC

Q

It does. Thanks. And just very quick follow-up here. The buybacks comes probably at the surprising time in your operations here. Can you just maybe give us a few points on why you do a buyback now? Thanks.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

Yes, I think it's just – this is just – we think this is just prudent. It just feels to us like – feels to me like we're entering a period of increased market volatility. I think in a period of increased market volatility having something on the shelf that the board has authorized, so that if the company decided it wanted to take advantage of dislocations in the market, it could do so. Seems like a prudent thing to do. There's a complex process to sort of make sure you're ready and it's on the shelf and so that's what we've done, but I don't think people should read more into it than that.

Oliver Wintermantel
Analyst, MoffettNathanson LLC

Q

Great. Thanks very much.

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

A

We probably have time for one more question, operator.

Operator: And our last question comes from the line of Michael Graham with Canaccord. Your line is open.

Michael Graham
Analyst, Canaccord Genuity, Inc.

Q

Thanks very much, and congrats on the progress, guys. Just one on international margins, Michael. Ever since at least Q1 2016, the trend has been gradually improving. I'm just wondering if you think as we get through this year, that each quarter would you expect international margins to keep improving? And any high level thoughts on how many years it might take to get positive there?

And then, Niraj, I just wanted to ask, on your e-mail you mentioned that some things take longer. I imagine you are referring to the international business, and I just wonder if you could put another player of depth, like what about the international business might have taken longer than you originally planned. Is it customer acquisition? Is it merchandising? Or whatever it might be, just to give us a little more color on that would be helpful. Thank you.

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

A

Sure. Michael, do you want to start?

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

Yeah, I'll start on the margin side. I think, we've talked about in the past couple of quarters that we have made some progress in the international business on gross margin. It still runs well below the U.S. business. I think we're at a place where we're seeing the combination of site experience, broad selection and supplier uptake sort of set a level of margins that we feel work near term, such that we can continue to sort of ramp-up ad spend and people there to build that business, thus the greater losses in that business that we guided to. And so I think we're sort of at the right place there.

Now, the way our business works is as we unlock more scale, we unlock more margin. We become a more important volume buyer from our suppliers, and we get flow-through on the logistics side. All of the pieces that sort of work, work well on a scale perspective, and so I think as we continue to ramp those businesses, we should be able to unlock more gross margin there. But we're sort of presuming at this point that we're going to run at the gross margin levels that we're at right now in the international business, and then as we unlock scale, we'll add to that.

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

A

Mike, on your question about the e-mail, obviously, certain things take longer than others. Your question on international, obviously, that's one of the things that I would agree takes longer. If you think about it, you effectively need to build everything that we've built – in the U.S. we're 16 years old. And so even though we didn't have a brand for the first decade, we'd built a lot of supplier relationships, a big product catalog. We had a transportation logistics infrastructure, a customer service infrastructure, and we had a lot of things intact. And then we augmented them with more visual merchandising, more brand building.

When you open up in a new geography – so Canada has a benefit, because it rides off a lot of that U.S. infrastructure, but Europe, for example, you're building supplier relationships from scratch. You're building a product catalog from scratch. You're building the transportation infrastructure from scratch. And so there's just a lot more you need to do.

And while you can hire a bigger team and do more in parallel, which is part of what we're doing, it's still a lot more, so it still takes longer, and I think it's kind of almost that simple. And customer acquisition and things like that are they're not a primary activity. They're a secondary activity. So until your customer offer is strong, you really aren't in a position to go out and acquire customers. And what's a customer offer? Well, a customer offer is based on selection and transportation and speed of delivery and customer service, and so it's really that first order that I'd say is where the time is really consumed.

Michael Graham
Analyst, Canaccord Genuity, Inc.

Q

Yeah. Okay. Thank you.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

Thanks so much.

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

Well, great. Thanks, everybody. We appreciate your time, and thanks for calling in. Take care.

Operator: This concludes today's conference call. You may now disconnect.