Wayfair Inc.

Fourth Quarter 2016 Earnings Release and Conference Call

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CORPORATE PARTICIPANTS

Julia Donnelly, *Head of Investor Relations*

Niraj Shah, *Chief Executive Officer, Co-Chairman and Co-Founder*

Steve Conine, *Co-Chairman and Co-Founder*

Michael Fleisher, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Seth Basham, *Wedbush Securities, Inc.*

Matthew Fassler, *Goldman Sachs & Co.*

Christopher Horvers, *J.P. Morgan Securities*

Oliver Wintermantel, *Evercore ISI*

John Blackledge, *Cowen & Co.*

Michael Graham, *Canaccord Genuity, Inc.*

PRESENTATION

Operator:

Good morning, ladies and gentlemen. My name is Melissa and I will be your host Operator on this call. At this time, I would like to welcome everyone to the Wayfair Q4 2016 Earnings Release and Conference Call. All lines have been placed on mute to prevent any background noise. After the speaker's remarks, there will be a question-and-answer session. If you would like to ask a question at this time simply press star, then the number one on your telephone keypad. If you would like to withdraw your question press the pound key. Thank you.

At this time, I would like to introduce Julia Donnelly, Head of Investor Relations at Wayfair.

Julia Donnelly:

Good morning and thank you for joining us. Today, we will review our fourth quarter and full year 2016 results. With me are Niraj Shah, Co-Founder, Chief Executive Officer, and Co-Chairman; Steve Conine, Co-Founder and Co-Chairman; and Michael Fleisher, Chief Financial Officer. We will all be available for Q&A following today's prepared remarks.

I would like to remind you that we will be making forward-looking statements during this call regarding future events and financial performance including guidance for the first quarter of 2017. We cannot guarantee

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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 2016 which we expect to file in the near-future, identifies certain factors that could cause our actual results to differ materially from those projected in any forward-looking statements made today.

Except as required by law, we undertake no obligations 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 is available for replay on our IR website.

Now, I would like to turn the call over to Niraj.

Niraj Shah:

Thanks, Julia, and thank you all for joining the call. I am pleased to share our fourth quarter and full year 2016 results with you this morning. I want to begin by telling you how proud and excited Steve and I are of what Wayfair accomplished in 2016. In part, that shows in the numbers we will share with you today, but it is also larger than that. These calls are unfortunately focused on extraordinarily near-term results. To us 2016 showcases what we've been building for the last 15-years. At the end of the day, it's all tied to our focus on serving our customer and having an amazing team of over 5,000 people.

We just finished writing our Annual Shareholder Letter that shares some of these thoughts. We posted this letter to our Investor Relations website today as part of our Investor Presentation. We could not be more excited to continue the journey in 2017 and beyond.

For the full-year 2016, we generated $3.4 billion of total net revenue, up $1.1 billion, and up 50% from 2015. At $3.4 billion in revenue, we believe we are just starting to penetrate the approximately $600 billion market opportunity we have in the Home category in the US, Canada, and Europe. In Q4 2016, we generated $959 million of net revenue in our Direct Retail business, up 40% year-over-year, and $985 million of total net revenue, up 33% year-over-year.

We saw Direct Retail growth across our US and International businesses and across many categories of the products we sell, but there are four particular areas that I'd like to update you on: Holiday, New Categories, International, and Logistics.

The first is Holiday, where we had another very successful season this year. As we have mentioned in the past, the holidays are a great time for us to attract new customers, and invite purchases from repeat customers. This year in Q4, we offered twice as many holiday events, with more than twice as many featured items as last year. In addition to our expanded selection of seasonal décor, we also saw shoppers buying furniture and décor items to spruce up their homes, and prepare for house guests, and buying storage and organizational items for the post-holiday cleanup. Some of our best-selling classes were TV stands, bar stools, recliners, bedding, upholstered beds, mattresses, rugs and outdoor furnishings.

In the seasonal décor category, non-traditional Christmas trees, like half and palm trees and holiday lighting experienced particularly strong growth. We also saw customers buying storage items such as artificial tree storage bags, ornament storage, wreath boxes and string light organizers. A significant percentage of seasonal décor sales in the quarter flowed through our CastleGate warehouses, enabling us to offer next-day and two-day delivery for popular items including our 5 for $25 ornament shop. As noted in our November press release, Direct Retail gross sales defined as dollars of order intake increased 52% year-over-year for the five-day peak shopping period of Thanksgiving Day through Cyber Monday with repeat

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customers accounting for 58% of Holiday sales. We also saw strong new customer acquisition during this period as it is typically a time of year when virtually all consumers are shopping online.

The second area I would like to highlight is the ongoing growth in some of the newer categories we are focused on such as home improvement, housewares, and mattresses. When we say home improvement, what we mean are the finished areas of plumbing, lighting, and flooring. We focus on the items that our target customer, a woman aged 35-years to 65-years, cares about, and wants to pick out herself. Think of fixtures like faucets and showerheads, bathroom vanities, sconces, kitchen backsplash, tile floors, and not the building materials like drywall, lumber, insulation, pipes and wiring. By building out a deeper product catalog, merchandising these items is better on our site, and hiring specialized sales and service teams in our customer service centers we have seen an increase in our penetration of these home improvement categories.

In housewares, part of our approach involves building up our Wedding Registry offering, which Steve will discuss in more detail later in the call. Our mattress business is a good example of a category we historically had on the site, but didn't merchandise well, or provide the right selections. Over the last year, we have started to make those investments, and are now using a multi-pronged approach that includes innerspring, foam, and bed-in-a-box mattresses across industry-leading brands as well as our private label Wayfair Sleep brand. Though we still have much work to do here and a big opportunity ahead, today the mattress category is an over $100 million annualized run-rate category that is growing nicely.

Now, I'll move on to our International business in Canada, the UK and Germany. Total International net revenue for full-year 2016 reached $270 million, up 136% year-over-year. In Q4 specifically, total International net revenue was $100 million, up 181% year-over-year. All of our international businesses leveraged a lot of the technology infrastructure and the advertising playbook that we developed in the US.

Our Canadian business is further able to leverage the supply relationships and the logistics infrastructure of our US business. While Canada represents a much smaller market opportunity than Europe, the Canadian business continues to perform even above our internal expectations due to the combination of a robust product catalog leveraging the US supplier-base of Wayfair.com, an increasing amount of product shipping two-day from our US CastleGate warehouses, and a Canadian home market that was, frankly, underserved by the competition. We have grown our base of local Canadian suppliers too, with approximately 18% of Canada net revenue in Q4 sourced from local suppliers. Since launching Wayfair.ca in January of 2016, our aided brand awareness in Canada has risen to approximately 50% today, as a result of the online ad spend and television campaigns we ramped up in Canada in 2016.

The UK business is also experiencing significant traction in performing to our aggressive plan. In Europe, we needed to lay more groundwork with local carriers for transportation and delivery, and with local suppliers for the product catalog. At the European trade shows over the last six-weeks, we saw increasing engagement from local suppliers who see us as a strong partner for them in e-commerce.

Although CastleGate is newer in Europe, with the launch of our first UK warehouse this past September, we're seeing strong initial interest from local suppliers and anticipate that the penetration of CastleGate will follow a similar trajectory as in the US. We're also taking advantage of our deep long-term and scaled relationships with US suppliers in enabling some of them to enter the European market for the first time by shipping containers directly into our UK CastleGate warehouse. Similar to Canada, we ramped ad spend in the UK in 2016, and have seen aided awareness levels rise to approximately 30%.

Our German business is intentionally earlier in its build than Canada and the UK, reflecting our decision to focus first on English-speaking countries. However, we are seeing nice growth in Germany as well, and we expect to spend more significant ad dollars there in the back half of 2017, as the offering improves closer to parity with the UK.

We continue to be excited about the unique opportunity we have in front of us to continue gaining share in the US and to win in these new international markets that more than double the size of our total addressable

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market. Michael will take you through this in more detail later in the call, but starting this quarter we will be providing additional financial information for our US and International segments.

Our International business remains our most substantial investment area, and this quarter the Adjusted EBITDA loss for our International segment was $24 million. The US businesses is obviously our larger business today; US Adjusted EBITDA for full-year 2016 was roughly breakeven despite the investments in new categories, logistics, and merchandising. For Q4, US Adjusted EBITDA was modestly profitable as you would expect given our normal seasonal pattern.

In the US, we're investing significantly in our logistics network as well as in the newer categories like home improvement, seasonal décor, and housewares that I discussed earlier. Let me update you now on our logistics initiatives including CastleGate and our Wayfair delivery network, or WDN for short. In talking with many of you there seems to be a bit of confusion about the differences between CastleGate and WDN, so I'll take just a few minutes here to clarify. Please also refer to our Investor Relations website where we have added additional slides to our Investor Presentation to help illustrate the various parts of our logistics operation.

When we look at logistics, we think about the two classes of goods that we sell: those that are small and light enough to fit through the UPS and FedEx networks for the last mile, or small parcel, and those that are too large to fit through those networks and must instead be delivered by two people in a truck, or large parcel. This is our internal terminology for these items, but keep in mind the name small parcel for packages is all relative in the home category. Our small parcel packages are actually quite large and bulky, measuring three cubic feet and weighing 30 pounds on average. Over time, small parcel typically represents 70% to 75% of our revenue, and large parcel typically represents 25% to 30% of our revenue.

Historically, we would integrate with our supplier' back end technology to gain visibility into their warehouse inventory, and process orders automatically. When a consumer placed a small or large parcel order on the Wayfair site, the order would get automatically routed to a supplier warehouse where the supplier would fulfill the individual order, package it, and place it at the end of their loading dock for Wayfair to arrange shipment to the customer. For small parcel shipment we would leverage UPS or FedEx, and for large parcel shipment we would use trucking carriers in combination with third-party, last mile home delivery agents. This is our traditional drop-ship model for small parcel and large parcel.

Now, our CastleGate fulfillment network is a network of large warehouses where we operate effectively as a 3PL for our suppliers, allowing them to store their small parcel and large parcel inventory in our warehouses and pay us storage, pick and pack fee. These warehouses are strategically located and utilize presorting and dedicated transportation to speed up delivery of these small parcel and large parcel items. This delivery speed, which includes next-day and two-day delivery for small parcel items, delights our customers with fast delivery, and benefits our suppliers and us with increased sales conversion.

Today, shipments from our CastleGate warehouses can reach 99% of the US population within two days. As we ramped our CastleGate warehouse capacity significantly over the course of 2016, and expect to continue in the first-half of 2017, it is a drag on our P&L as the warehouses are not yet at full capacity and we bear the burden of unutilized rent expense. Over time, however, we expect cost benefits as warehouses reach full capacity and utilization, and as we take advantage of scaled benefits in transportation.

On our last call, we noted that approximately 10% of our US net revenue at the time was promised to and delivered to the customer either with next-day or two-day delivery. We expect that this percentage will continue to ramp quickly as we expand our capacity and suppliers increasingly flow product to our CastleGate warehouse.

The Wayfair Delivery Network or WDN, describes several different areas of our large parcel network, where we have started to take direct operating control of our transportation and delivery, instead of relying on contracted third-party operators. Examples include our Wayfair operated consolidation centers, cross docks, line haul, and last mile home delivery facility. Historically, we have relied on various third parties to

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operate our large parcel delivery network; five years ago, we relied on a single national delivery partner for all orders, as we got more scale, we were able to contract directly with third-party LTL carriers, and third-party last mile home delivery agents to reduce costs and provide a better overall delivery experience for the customer.

Today, with the additional volume and scale we have, we can now operate our own consolidation centers, and cross docks and run our own full truckloads between those points. By taking more direct control of this so-called middle mile for large parcel orders as they crisscross the US, we can increase the average speed of delivery, reduce transportation costs, and reduce damage since there are fewer touch points per order. We can also influence damage rates by instilling a culture where everyone who touches the product cares about delivering it damage-free to the Wayfair customer who ordered it. By the end of 2017, we expect to have approximately 90% of our large parcel shipments flowing through the Wayfair-controlled middle mile.

Today, we have also started to operate our own last mile home delivery facility in major metropolitan areas so that we can increase customer satisfaction on large parcel delivery. Inside the four walls of a last mile home delivery facility, Wayfair employees are handling the products and interacting with customers to schedule deliveries or answer questions. These facilities also use our proprietary technology. Delivery out to the customer's home is now provided by trained partners with Wayfair experience. We direct the routes that the trucks take and have a feedback loop and incentives that drive behavior consistent with our brand, including bonuses based on the NPS score provided by the customer after they receive their delivery.

At the end of 2016, we were operating six of these last mile delivery facilities, and we plan to have 15 to 20 in operation at the end of 2017, covering approximately 60% of the US population. Large parcel deliveries are a pain point across our entire industry. By working towards a future where the only people touching the product are Wayfair representatives who carry our culture of caring first and foremost about the customer, we intend to transform what can often be a negative consumer experience into an opportunity to continue delighting our customer.

I'll now turn the call over to Steve, who will give you an update on our private label credit card, and our new Wedding Registry offering.

Steve Conine:

Thanks, Niraj, and good morning everyone.

We are always thinking of new ways to increase loyalty across our customer base. One example is our private label credit card which fully launched in early 2016. We market the Wayfair credit card to our customer base by prescreening customers at checkout to notify them if they are preapproved, and through banner ads on our site and our television commercials. Customers can also apply directly for the card through our site. Benefits of the card include special financing offers, rewards points and a discount off their initial order. We partnered with Alliance Data for the card and it is Alliance Data who bears all the credit risk, holds those receivables on their books, and handles the customer payment process.

Our results show that our private label credit card customers visit Wayfair more frequently and spend more than our average customer. We believe this is because the card attracts more loyal customers and further increases their loyalty by spurring higher activation and repeat, once they're a cardholder. Though it is still early, private label credit card sales in Q4 accounted for approximately 10% of our US-direct revenue, and we expect that percentage will continue to grow.

We also recently introduced a financing offer with Affirm to help those customers who wish to finance larger purchases but do not want or qualify for a private label credit card. Similar to the card, we do not bear any of the credit risk for these financing transactions. While Affirm is a relatively new offering, we are excited by the customer reactions so far. These programs are the beginning steps of our larger loyalty rollout. For example, the private label credit card is a great platform to give our best customers special benefits which could include early access to new products or complimentary services.

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I also wanted to provide an update on our Wedding Registry offering. As we've said before, it is still early days for the Registry as it typically follows a seasonal pattern with the majority of revenue realized later in the year as weddings take place. We are encouraged by the early customer response so far, with 50,000 registries created since launching in September. We also excited to see early evidence of customers taking advantage of the full Wayfair selection with customers registering both for traditional registry items, like housewares, and for larger ticket items like couches and dining room tables.

Alongside building our registry offering, we have also built out our housewares offering with top brands now available on our site. In addition to the potential revenue we can realize from the registry business, this offering has also been a great way to acquire new customers. Our early results show that almost half of registries created to-date come from customers who are completely new to Wayfair, allowing us to reach new customers just as they reach the stage in their lives where they begin to spend a greater portion of their income on their home. In addition, we are introduced through registry to all of the wedding couple's friends and family, which is yet another source of customer acquisition.

I'll now turn the call over to Michael to walk through the financials.

Michael Fleisher:

Thanks, Steve, and good morning everyone. As always, I will highlight some of the key financial information for this quarter and full-year 2016. More detailed information is available in our earnings release which can be found on our IR website.

In Q4, our Direct Retail net revenue increased 40% to $959 million, and our total net revenue increased 33% year-over-year to $985 million. Our Other business, which includes revenue primarily from our retail partners but also includes revenue from our small media business, continued to decline, reaching $26 million as we continue to ramp down our retail partner business over time.

As Niraj mentioned, we're particularly pleased with our holiday execution this quarter, as well as the ongoing growth throughout the year from both existing and new categories, and from our US and International businesses. In full-year 2016 we reached $3.4 billion in total net revenue, adding $1.1 billion in net revenue compared to 2015. We believe our well-rounded consumer offering of extraordinary selection and visual merchandising, world-class and personal customer service, and a great delivery experience are making it easier than ever before to buy home goods online and we see that really resonating with our mass market customers.

The remaining financials I'll share on a non-GAAP basis, excluding the impact of equity-based compensation and related taxes which totaled $14.7 million in Q4 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 $239 million or 24.2% of total net revenue. Gross margin percentage ran a bit higher than we had initially expected for the quarter. We typically enter Q4 prepared for an intense promotional environment, and even though our business model does not necessitate lowering prices and margins to move product like inventory-based retailers, we usually anticipate we will need to price accordingly. A combination of a less intense pricing environment and really great work with our supplier partners to have the sharpest wholesales on our most popular item, led to a higher gross margin yield than our current target of about 23%.

Advertising spend was 11.8% of net revenue in the quarter, or $116 million Year-over-year advertising spend as a percentage of sales improved slightly by 10 basis points from Q4 2015 when it was 11.9% of net revenue. As we've described in the past, revenue from repeat customers averages down our ad costs as a percent of net revenue because it costs us much less to stimulate an order from a repeat customer than to acquire and stimulate an order from a new customer. Since our International business is newer

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than our US business, it does not yet have the benefit of substantial order volumes from repeat customers, and therefore runs at a higher ad cost as a percent of net revenue.

As our International business continues to grow rapidly, it puts upward pressure on the consolidated ad costs as a percent of revenue. That upward pressure is being offset by the US business, and therefore results in a consolidated ad spend as a percent of net revenue for the quarter that is roughly flat year-over-year, as anticipated.

In Q4, we added approximately 888,000 net new active customers, making it the largest quarter of net new customer acquisitions to date. We ended the quarter with 8.3 million active customers, up 54% from Q4 2015. Of the total orders in Q4, 58% came from repeat customers and 43% were made from a mobile device.

As we've mentioned in the past, we think of Average Order Value more as an output and not an input. We want to grow our share of wallet as measured by net revenue per active customer, and all else being equal, we'd like to drive order frequency as measured by LTM orders per active customer. In any given quarter, however, mix shift as our International business accelerates, or mix shift across categories as some of our new categories grow more quickly or influence our consolidated KPIs. Q4 is usually a period of lower AOV because holiday purchases tend to be lower ticket. As part of our overall goal of driving order frequency, we learned in harder this quarter on higher frequency, lower ticket items such as sheet sets or throws, and therefore saw a larger decrease in AOV. You can see this trend across several of our KPIs this quarter, with repeat orders up 41% versus last quarter, LTM orders per active customer back up to 1.7 from 1.69 last quarter, and AOV down 17% versus last quarter. The combination of this and the continued increasing mix of our International business that still has a much lower revenue per active customer caused that metric to decline 3% sequentially to $395.

We offer our customers over 8 million items, which makes managing AOV in any particular period impossible, and the reason we see it as an output and not an input. We're focused on striking the right balance between driving frequency, gaining wallet share, growth, profitability, and as always most importantly, showing our customer the right product for her from our vast selection. I anticipate that will continue to be some fluctuations in our various KPIs, as we've seen in the past, as we continue to grow International and newer categories, as well as strike the balance between frequency, AOV and revenue per active customer.

Our non-GAAP merchandising, marketing, and sales expense, and operations, technology and G&A expense are driven primarily by compensation costs. In Q4, these two line items combined were $116 million, roughly flat on a dollar basis when compared to Q3, as anticipated, on a reduced level of hiring this quarter and last. As we've indicated on the past calls, the first half of 2016 represented a catch-up period in hiring, and we now feel that our key strategic initiatives are well-staffed. As a result, we added only 27 net new employees this quarter, bringing total headcount to 5,637 employees as of December 31. In 2017, we intend to add additional headcount in areas such as warehouse and customer service, which is a variable cost needed to keep up with growth, and in our op ex areas to continue to support our key growth initiatives and investment areas.

Adjusted EBITDA for the quarter was negative $12 million, or negative 1.2% of net revenue on a consolidated basis.

As Niraj noted earlier, this quarter we will begin breaking out our Direct Revenue, Other Revenue and Adjusted EBITDA separately for our US segment and for our International segment. Those numbers are in our press release and our Investor deck on our IR website, and will also be available in the 10-K when it is filed in the next few days.

I will walk you through the highlights now, but please note that we do not intend to provide additional segment level information, including KPI information, except that we will continue to provide qualitative commentary on some of the drivers in our quarterly earnings calls as we've done in the past.

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For our US segment in Q4, Direct Retail net revenue reached $859 million, up 31% year-over-year, and total net revenue reached $884 million, up 26% year-over-year. US Adjusted EBITDA was $12 million in Q4 2016 and $0.2 million for the full-year 2016. This compares to US Adjusted EBITDA of $18 million in Q4 2015 and $31 million in full-year 2015. As you can see, the US business is essentially breakeven today.

On the one hand, our US business is providing the leverage for our International investment, by delivering strong gross margins and ad spend leverage. On the other hand, we continue to make substantial investments in the US business to drive future growth. As we've discussed, these investments include headcount focused on new categories, like home improvement, housewares and mattresses, new businesses like Registry and the rollout of our logistics network including CastleGate and WDN. The logistics investment also shows up as a drag on US op ex as the unutilized portion of warehouses is expensed there. The new categories also drive lower gross margins as they ramp to scale. The strong unit economics of our US business are funding these initiatives and we believe that without these investments the US business itself would be clearly profitable.

For our International segment in Q4, total net revenue reached $100 million, up 181% year-over-year. International Adjusted EBITDA was negative $24 million in Q4 2016, and negative $89 million for the full-year 2016. As we've described on prior calls, gross margin is lower internationally as we are sub-scale and do not have the same negotiating leverage with suppliers on wholesale costs or efficiencies in transportation and delivery as we do in the US. Ad costs as a percent of net revenue also runs higher than in the US because the International business is newer and does not yet have the benefit of significant repeat orders. Our op ex is also meaningful with 12% of our total headcount located overseas as of December 31, 2016, as we build the local organization to manage the business and plan for anticipated future growth.

As Niraj mentioned, we continue to be very excited about the unique opportunity we have in front of us to continue gaining share in the US and to win in these new international markets that roughly double the size of our total addressable market.

On a consolidated basis, non-GAAP free cash flow was $49 million for the quarter, driven by net cash provided by operations of $73 million less total capital expenditures of $25 million, equal to 3% of net revenue. As a reminder, due to the seasonal impact of holiday sales, Q4 tends to be a quarter where our change in networking capital becomes a significant source of cash. We expect cap ex to run at approximately 4% to 5% of net revenue per quarter for the first half of 2017 as we continue to build out CastleGate warehouses and then moderate in the back half of the year. For the full-year 2017, we expect cap ex to run at approximately 3% of net revenue.

As of December 31, 2016, we had approximately $380 million of cash, cash equivalents and short- and long-term investments. Our near term goal remains running the business at free cash flow breakeven to positive, so that we will continue to be self-funding.

Now, let me turn to guidance for Q1 2017. We forecast Direct Retail revenue of $890 million to $910 million, a growth rate of approximately 25% to 28%. As I've done in the past to provide transparency, our Direct Retail gross revenue quarter-to-date is growing approximately 30%. As always, we aim to set guidance in a prudent fashion that takes into account that we are in a mass market consumer business, where our customer needs to show up every day. Last quarter I mentioned that the state of the macro-retail environment was unclear; I believe that is still the case today. Some retailers have reported weaker than expected results and delayed IRS refunds to households that fit our customer demographics will have an impact on the timing of revenue during the remainder of the quarter. We have continued to see strength with our customers and believe the transition from brick-and-mortar to online remains the key market driver for our growth. But at our scale we will certainly feel the impact of any changes in consumer sentiment and behavior, both positively and negatively.

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It's also worth noting that Q1 last year is an extraordinarily difficult comp. As such we remain conservative in our guidance of growth rate. We forecast Other Revenue to be between $15 million to $20 million, with total net revenue of $905 million to $930 million for the first quarter.

For consolidated Adjusted EBITDA we forecast margins of negative 3.5% to 3.8% for Q1 2017. We expect Adjusted EBITDA for the International business to continue its recent trajectory as we continue to invest. We expect Adjusted EBITDA for the US business to swing to a modest loss in Q1, following the modest profit in Q4, due to typically lower sequential revenue following the Q4 holiday, and higher sequential ad costs as a percent of revenue since we generally lean in on advertising this time of year to take advantage of very attractive market pricing. We continue to feel our strategic initiatives are well-staffed and anticipate only a modest amount of hiring in the quarter, consistent with recent trends.

For modeling purposes for Q1 2017, please assume equity based comp and related tax expense of $17 million, average weighted shares outstanding of $86 million, and depreciation and amortization of approximately $20 million.

One other item to update you on is the recent signing of a new banking relationship with Citibank and Silicon Valley Bank. As you may recall, we previously worked with Bank of America for a variety of commercial banking services including our unused line of credit and corporate credit card program. With this new deal, we were able to negotiate a better overall deal, including better terms on the credit card program and a larger quantum on the line of credit.

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

Niraj Shah:

Thanks, Michael.

In closing, I'd like to reiterate how proud I am of what we have accomplished in 2016 and how we are positioned going forward. Shopping for home goods is moving online in North America and in Europe and we think we will continue to be the beneficiary of that secular trend. We have a large addressable market and we are still in the early innings of online penetration with approximately 9% of the categories sold online today in the US. Our overall offering is increasingly complete, with house private label brands, a significant Wayfair brand presence and superior customer service. Our key investment areas will help us up our game even further by expanding next-day and two-day delivery coverage, adding new categories for our consumer to buy from us, and expanding into new geographies where we can leverage our experience. We are looking forward to a great 2017.

We'd be happy now to take your questions, so I'll turn the call over to the Operator.

Operator:

Thank you. At this time, I would like to remind everyone in order to ask a question press star, then the number one on your telephone keypad. We ask that you please limit yourself to one question.

Your first question comes from the line of Seth Basham from Wedbush Securities. Your line is open.

Seth Basham:

Thanks a lot, and good morning. My question is just around the cadence of your sales for the last four months. It seems like after your last conference call you indicated you're running north of 40% in terms of Direct Retail revenue growth, you had a very strong Cyber Five and based on your quarterly results suggest a slowdown in December and then a further slowdown in January based on what you said. Could you help us understand what might be driving this slowdown and how you think about the outlook over the course of 2017?

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Niraj Shah:

Sure, Seth. It's Niraj. Thanks for joining the call. In terms of your question, I think the Cyber Five period is always a particularly strong period so you've got to just view that a little bit in isolation versus like a trajectory data point as you're mapping through the numbers. I think what you've been seeing us guide is that growth from a year ago, where we were approximately 100% growth, has decelerated more to sort of normal numbers where we're taking a significant share but at a rate a lot lower than that, and that trajectory kind of is playing out. I would just view the guidance as sort of part of that kind of trend where you're kind of settling into a rate that's a good growth rate, particularly in light of the fact that the bulk of the money we're investing is actually for long-cycle investments that aren't showing up in the growth rate today. So, I don't think there's anything (acute (phon) in the last few months where one month or two months are showing a deteriorating trend or something like that. I'll let Michael comment because there's always some uncertainty about macro based on what we hear from others, but to be honest we usually have a pretty hard time reading it except in arrears.

Michael Fleisher:

That's right. Let's just be clear, last quarter I think we said that we were growing quarter-to-date at the time of about 40%; I don't think we implied that we were north of that and I think we came in pretty much where we were growing at that time through the balance of the quarter. Obviously, you try to figure out sort of what's going on in your own business and then also what's going on in the macro environment. As I noted in my comments, I personally believe the macro environment for retail is unclear. There's certainly some things out there that look like the macro-environment is quite strong and then there's other factors that look like it's not—the consumer is not as strong.

The one piece I'd note that makes this quarter for us, one macro piece on logic certainly is the IRS is getting early refund checks out to consumers. If you think about the nature of our consumer, a 45-year-old woman with an $85,000 household income, she is someone who might have a $500 bedroom set in her idea board ready to purchase when she gets her IRS $1,000 refund check.

Seth Basham:

Okay, that's helpful. As you think about the outlook for 2017, moving to the EBITDA line, would you expect an inflection to positive at some point this year?

Niraj Shah:

Michael loves it when I give out guidance, so I generally leave that to him. But you know what I've said a number of times is we absolutely want to be in a position where we're self-financing the business. We've been there for over a decade of our history, so that's the way I would describe it. Michael, do you want to give some guide?

Michael Fleisher:

Seth, the thing I might point to is obviously this quarter we've now broken out two segments, right? The US business and the International business. Obviously, the International business is a substantial investment. You can see that just now we're investing in that business at the EBITDA line in a fairly consistent way, and so I think it's fair to assume that that's going to continue.

At the same time I think the US business, as I noted in my prepared remarks, right? It was profitable in the fourth quarter. It makes sense, it's a big quarter for us and there's sort of sub-holiday seasonal inflection. I expect that business, the US business, to swing to a modest EBITDA, Adjusted EBITDA loss in Q1, but you can see now the economics of that business is that as that business continues to grow at this pace, the flow through will be there, and so I think it's not hard to run out the numbers of what's going on in the

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US business, the investment levels we're making, and the International business to sort of get to a place where you can see the inflection point. First, the US business needs to be running at a profitable basis, and then over time the US business profitability will be high enough to be covering off the International investment.

Seth Basham:

Great, thanks for the call. I'll turn it over.

Operator:

Your next question comes from the line of Matt Fassler with Goldman Sachs. Your line is open.

Matthew Fassler:

Thanks a lot; good morning to you. I've got a quick two-parter on gross margin. The first relates to your comments on the promotional environment. You might be the only company in years to say that it wasn't as bad as you feared. That was obviously borne out in the gross margin, but a little more color on what was better, and where you saw the lack of pressure would be helpful. Then just also briefly on gross margin, as your mix tilts slightly towards some of those newer categories, if you could discuss the implications for gross margin and contribution margin, if you can get it down to that level for those new businesses? Thanks so much.

Niraj Shah:

Okay. Hey, Matt; it's Niraj. Thanks for your question. So on the gross margin, the first question about the promotional environment, I guess the way we think about that, Holiday is most acute time of the year for promotions, although, to be honest, we live in an environment where promotions are always running and that's part of your merchandising strategy. When you enter Q4, you really don't know what your competitors are planning to do, and you can have cases where competitors frankly are giving away goods in certain areas just to stimulate their overall business or, frankly drive a certain business line or whatever, so you're not sure what you're going to see. You have your own plan that you really like, you feel like you know what your customers want, you feel like you know where you have good value to show, but what happens is you have a lot more uncertainty than you have at other times of the year. What we're saying is just that when we led with the offers we thought were great, we have—you have to have a huge supplier base. We don't carry the inventory, but we work with our key partners to plan on what we think will work well. We've just seen great success and what we didn't see was cases where competitors were just kind of giving away items just to try to drive that volume, and so kind of it seemed like a healthy environment to us where people were focused on making money and there wasn't that oddity.

In terms of new categories and the play out in gross margin and contribution margins, I'd almost tell you it's a thing to think about, it's exactly what you said, it's a contribution margin. The reason is—so when you have a new category, gross margin is going to be quite low, and then frankly, its volume is going to be quite low, so it's a drag on gross margin and that's it. Then you will have a period of time where it starts ramping, while your gross margin is going up, your actual drag on your company's gross margin percent will become bigger, but your gross margins actually getting better and better and might even be producing a little bit of contribution margin, maybe from a place where it was producing zero contribution dollars. Then as it gets bigger and bigger, it actually will have a gross margin much more in line with the mature parts of the business, now have really good contribution margins. So, if you focus on the contribution dollars portion of the contribution margin, you actually have really nice curves, where you kind of start off not expecting much and then as you ramp it, you're basically putting in the logistical finesse, you're getting the buying power, you're getting the volume from the suppliers, and all of a sudden you are getting the profit sellers out. The journey there, you kind of need to not worry about the gross margin percentage drag it creates; it doesn't really create a dollar drag if you do it right, and so that's the way I think about it.

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As we have more and more of these take-off, we hope in the not too distant future, it might create swings in the gross margin percentage, but if you look at the variable contribution margin dollars, you should see the trends you want to see, where we continue to grow that nicely. Then to be honest, the more you have some of these take off, the more you know not so many quarters out to see it kind of be nice and (inaudible) in the contribution dollar.

Matthew Fassler:

Thank you so much, Niraj. Appreciate it.

Michael Fleisher:

Thanks, Matt.

Operator:

Your next question comes from Chris Horvers from J.P. Morgan. Your line is open.

Christopher Horvers:

Thanks. Good morning guys. A couple of follow-up questions, first on Matt. So, on the gross margin, it was up 40. You had modeled it down, I think, 23 to 25, so that—roughly a 100-basis point swing. Would you say the delta versus plan was, was it evenly split between the promotional environment and the vendor support? Related to that, could you talk a bit more about what exactly vendor support is? Is that scaling the business? Is that exclusive items and private label items that you're offering, and helping the mix and so forth?

Michael Fleisher:

Yes, it's Michael. Thanks, Chris. It's hard to—it's a little hard to split it between the two because in some ways they work hand-in-hand. What I mean by that on the supplier side is that we've gotten better and better in our relationships with our suppliers, have gotten larger and larger, where we are much earlier in the year now planning with our key suppliers which products we think are going to have big value with our customers during the Holiday. Therefore, making sure that they have enough inventory on hand, but even more importantly to this discussion that we're getting the sharpest possible wholesale on those items that we're going to go highlight to our customers as part of those promotions. Remember, we've talked on previous calls about shooting some of the photography and the imagery and doing the visual merchandising much, much earlier in the year and sort of be really prepared for that. Part of that is the relationships, the negotiations with the suppliers and get your best possible wholesale and that's really what helps in this environment because you already are in a place where you're running at a great price for the customer, but you've got enough margin for us and enough margin for the supplier to make it work all the way through the chain.

Niraj Shah:

This is Niraj. One thing I'll just jump in with, Chris, I think it's important to note that a large amount of what you see when you look at our total company gross margin you see it move around, it's actually mix. You have mix from the different international businesses that are in different places in their lifecycle, different margin levels. You see mix between the different things happening in the US, different categories and the different retail brands. So there's a huge amount of the swing that actually if you had all of the component parts you would say it's just a mix effect and then if you isolated it and you dove into one area, you get into what Michael was really discussing. But yes, I'd be careful not to try to bucket it into those two buckets you have because it's not that clean a read.

Christopher Horvers:

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Understood. Then, so as we think about going forward, do you continue to advance the planning process with the vendors such that you know we could see continued gross margin improvement into 2017?

Niraj Shah:

I mean we've always said there's a lot of opportunity in gross margin through three things. One is transportation savings. If you think about last year, you look at the business, transportation, advertising and op ex, headcount were all round about $400 million cost. That transportation $400 million, as you add a lot of finesse, as you have volume you can add finesse in terms of how you bring a product in more efficiently and how you manage the whole cost from the moorage (phon) and location of the back break, into bringing it into the domestic market that you're selling it in, getting closer to the end customer, how the transportation through to the last mile works. So, there's a significant amount of efficiency you get there.

Second is buying power with suppliers, as you mentioned, and the third, you also touched on which is if things are private label or they're house brand you start getting a lot more pricing leverage, per se, in the sense there is not direct match to some of the items in the market. So, all of those unlock gross margin. Then what you tend to do is you're giving some of that also back to the customer in various ways, whether that be loyalty programs or that be certain types of—you might do things to reduce damage that have net cost savings, but basically may look a year from now that it's hurting your gross margin in the long term actually. So, there's all kinds of different puts and takes, but we do think there's continued gross margin to get at the very significant magnitude.

Michael Fleisher:

Yes, and to your point, on sort of near term, I think we are still targeting the 23s, I think that's where we'd like to be priced. So as Niraj just mentioned that sort of litany of all these things that are positive to gross margin, we also want to then make sure we're sort of using those to sort of be priced well in the market and that obviously that that balancing act is sort of in terms of driving growth penetration and customer satisfaction.

Christopher Horver:

Understood. Thanks very much.

Michael Fleisher:

Thanks, Chris.

Operator:

Your next question comes from the line of Olie Wintermantel from Evercore ISI. Your line is open.

Oliver Wintermantel:

Yes, good morning guys. Michael, you mentioned cap ex is going to run 4% to 5% of revenues in the first half and then for the full year about 3%. Can you maybe help us break that out for International versus the US?

Michael Fleisher:

Sure. It's a little hard to hear, but I think the question is about cap ex and then sort of thinking about International versus the US.

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There's really sort of two primary buckets from a cap ex perspective, generally, the logistics warehouse build out which is primarily steel racking - remember we have a sort of a very low capital intensity around these warehouses we're building. We don't have a lot of automation, conveyors, etc. and so there's that piece, and then the other piece is sort of what I would call the more normal cap ex of technology and infrastructure.

The vast majority of that is deployed within the US. We have one—we have our sort of first CastleGate warehouse facility in the UK now, and obviously we've invested on the technology infrastructure side in Europe as we've sort of built out a datacenter and sort of people there. But I would say the vast majority, it doesn't look—I don't have it in front of me, but I'm guessing it doesn't look that dramatically different then the revenues split right now.

Oliver Wintermantel:

Okay, great. Then translating that into maybe on the EBITDA level, so you mentioned the US is going through a slight negative in the first quarter, and then assuming that probably in the fourth quarter '17 it should turn positive again like the last two years. Is it then the cadence also that maybe the second or third quarter we're wrap-around break even or slightly down and then turning positive for the fourth quarter? Is that fair?

Michael Fleisher:

I'm going to be extra careful not to be guiding the next few quarters as opposed to just guiding the current quarter that we're in. Look, I think one of the reasons we gave everybody eight quarters back of the split between the US and International was so that you can see some of the seasonal pattern. Obviously, somewhat that's interrupted by investments being made, so you can see that investment line for International and US in the 2016 numbers, but I think it sort of sets up a reasonable pattern when you start to think about what the business might look like going forward.

Oliver Wintermantel:

Thanks very much.

Michael Fleisher:

Thanks, Olie.

Operator:

Your next question comes from the line of John Blackledge from Cowen & Co. Your line is open.

John Blackledge:

Great. Thanks for the questions. So, with a strong repeat customer rate in the fourth quarter, how should we think about potential ad leverage in the US in 2017? Any kind of sense of kind of US ad spend as a percent of total revenue? Then secondly, on Registry, it's seasonal, we've been hearing about it for a while, it should help in 2Q and 3Q. Is there any way to kind of frame or quantify the impact to the US business this year? Thanks.

Niraj Shah:

Thanks, John. It's Niraj. On your first question about strong repeat customer rate, has that translated to ad spend in the US, a couple of puts there. One of the things we've mentioned a couple of times is that if you look back over the last year, we've actually been constraining the US ad spend to actually even less then the payback period that we generally would allow it to go to because what we've been doing is

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allocating more ad spend to International while overall looking for leverage on the ad spend line as a total company. So, you could say that's short-sighted in the sense that we should spend more in the US, but we think it's the best outcome for the long run, to actually build these International businesses. That's been a long run benefit straight off we've made for the short term, less benefit in the US.

So what will happen this coming year is that I don't know that we are interested in constraining it to the point where we're really like leaving a lot of low-hanging fruit out there, so ad spend is not necessarily the place I think that you should look to see a lot of leverage. I think we want to continue to acquire customers that are really nice fast-paced, where frankly, we're getting really good payback. We're not looking to add a huge amount of deleverage either, but we're not looking to kind of squeeze ourselves to where we're not taking advantage of good opportunities. That's the…

Michael Fleisher:

Yes, and the one thing I'd add too as the international businesses continue to mature and we're obviously making substantial investments there still, but we would hope that as those businesses start to get a (repeat base of customers and start to build, even though as their mix grows it hurts ad spend as a percent of revenue in total, their level of ad spend as a percent of revenue is getting better, and therefore, sort of it weighing less and therefore the US has to make up less.

Niraj Shah:

Registry, the thing I'd point out on Registry, the Registry is a longer cycle thing, right? Because you're marketing to folks now, they setup their registry, they get married in the spring and summer, and that's probably when the purchases occur and because this is our first real annual cycle, what we're doing there is we're frankly—we are marketing it, we are advertising but it's one of those things where we have a—we're using quite a good plan, it's reasonably ambitious but should it work well then what you would do is you would increase it substantially, but that would be for the following year. Because it's really an annual cycle, you don't have the ability like we do with most of our ad channels is continually adjust and increase it because you kind of have one specific period when you get the customers and then it takes quite a few months for you to see how it's payback was and then adjust it again.

So, that one I wouldn't expect to see huge impacts on the US financial performance this year from it because it's so new, and it takes a little while for that feedback cycle to work. But we really do like that business because if you think about those customers, you talk about the millennials, you know 70 million people between 17 and 34, well they're just starting to get married. They're the folks who then for the next 20 years will be home goods buyers as they start their families and they buy their house and all this. So, that's really the strategic benefit of it, but it'll take a few years for that to really cycle up to be—in terms of our share of the registry market and things like that.

John Blackledge:

Thank you.

Michael Fleisher:

Thanks, John. I think maybe we have time for maybe one more, Operator.

Operator:

Thank you. Your last question comes from the line of Michael Graham from Canaccord. Your line is open.

Michael Graham:

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Thank you. I just wanted to ask on growth in the domestic business, just going back to something. We first roughed in a number for Q1, we sort of get high teens growth for Direct Retail revenue for the domestic business. I know Q1 last year was another tough comp. I'm wondering if you have line of sight on things that could help that domestic business re-accelerate as maybe some of these new categories or new offerings get big enough in the mix? Or do you more see the domestic business on a glide path to mid-teens and lower? Just any color there in general terms would be helpful.

Niraj Shah:

Yes, sure, Mike. A couple of thoughts. First, I don't have, obviously, your model in front of me, but some of the numbers you're throwing out strike me as perhaps being a little low, but the way I would phrase it is remember what we've been doing here is we've been allocating money away from the US to the International. Then within the US, we've been allocating money disproportionately more into longer cycle benefits than near term benefits, longer cycle meaning building up these new categories, meaning these two logistics networks, CastleGate and Wayfair Delivery Network, which actually are proving to have very substantial benefits but they take longer to roll out to really scale to affect large percentage of the business. But we think that's actually—we've been working on these things for a year and a half, two years in some cases, and they're starting to really take share and grow quite well.

To answer your question, there are significant things that should affect the US businesses, that still need to grow, to drive repeat, drive new customer acquisition, the overall growth rate that are continuing to come online that we would expect to be very stimulative.

That said, I also think your numbers are a little low and so the way I would characterize where we would like to be is we want to be a significant share taker, so if you believe that the overall market is growing at 15%, you would then want to be meaningfully above that. If you believe the total market was growing at 10%, you'd want to be meaningfully above that; if the total market was growing at 20% rate, you'd want to be meaningfully above that. We think the overall market online is growing around 15%, plus or minus, and so we wouldn't be very happy if we were growing at 15% for a prolonged period of time. We'd want to be growing at very significant rate above that while still preserving our unit economics, not using advertising to be stimulative to it, not using pricing to be stimulative to it, rather through the strategic things like the logistics and like the merchandising, building up these categories, the customer experience on mobile, all these types of things. So, I realize that's not maybe specific guidance for you, but that's the way we think about it, and that's the way we look for it to play.

Michael Graham:

Okay, that's helpful. Thank you.

Operator:

Thank you.

Niraj Shah:

Everyone, I think that wraps up the questions so I'll turn it over to the Operator, but thank you for joining us this morning.

Operator:

Thank you. This does conclude today's conference call. You may now disconnect.

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