09-Aug-2016

Wayfair, Inc. (W)

Q2 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name Stephanie, and I will be your host operator today. At this time, I would like to welcome everyone to the Wayfair Q2 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. [Operator Instructions] Thank you.

I would now like to introduce Julia Donnelly, Head of Investor Relations at Wayfair.

Julia B. Donnelly
Director-Strategic Finance & Investor Relations, Wayfair, Inc.

Good morning and thank you for joining us. Today, we will review our second quarter 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 make forward-looking statements during this call regarding future events and financial performance including guidance for the third quarter of 2016. We cannot guarantee that any forward-looking statement will be accurate, although we believe that we have been reasonable in our expectations and assumptions. Our 10-K for 2015 and our subsequent SEC filings, identifies 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 replacement for and should be read together with GAAP results. Please refer to Investor Relations section of our website to obtain a copy of our earnings release which contains descriptions of our non-GAAP financial measures and reconciliation 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'd like to turn the call over to Niraj.

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

Thanks, Julia, and thank you all for joining this morning. We are pleased to report our second quarter results and share with you some exciting initiatives we have underway. We generated net revenue of $787 million in Q2, up 60% year-over-year and $756 million in our Direct Retail business, up 72% year-over-year. This represents Direct Retail dollar growth of $315 million versus Q2 2015, making this the third quarter in a row where the Direct Retail business has added over $300 million in revenue year-over-year.

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

A key part of our value proposition is our ability to deliver home products to the customer quickly and conveniently. I'd like to update you on some of the strategic initiatives that we began to pursue over 18 months ago to improve and expand our domestic transportation and logistics infrastructure. Our business model has always been somewhat of a hybrid model, giving the customer a seamless, branded, first-party experience while leveraging a drop-ship model, where we have leading selection yet take little to no inventory.

We believe this model allows us to focus on the things we are good at: merchandising, marketing, sales and service, all underpinned by great technology; while allowing our suppliers to focus on what they are good at: product design and development, sourcing and manufacturing. The area of the physical value chain where we and our suppliers meet is domestic logistics; the domestic warehousing and its integration into transportation and delivery to the customer, an area where we have historically invested in back-end technology integration with our suppliers to enable a seamless customer experience. With the scale we now have, we are optimizing the warehousing transportation and logistics part of the value chain in order to meet and exceed customer expectations.

It's important to note that after product cost, we have three cost lines that are roughly of the same proportion of costs today: advertising, which is to get customers; operational expenses, which are mainly driven by the team that is building the business; and transportation. Transportation expense is the only cost that can be optimized and lowered on a per-order basis while benefiting all participants in the value chain: Wayfair, our suppliers and most importantly our customers. Today, the majority of our product is shipped individually from the suppliers' warehouse to the customer, whether that product is a small table lamp, where the last mile delivery can be by FedEx or UPS to the customers' door or a large sectional sofa that must be delivered by a local trucking company, brought into the customers' home, unpackaged, and sometimes assembled.

Under our CastleGate program that began in earnest in early 2015, we are forward positioning our suppliers' highest volume products in our warehouses, so that we can ship these products from our warehouse directly to the customer often with a next-day or two-day delivery guarantee. With CastleGate, we effectively act as a third-party logistics provider to our suppliers, taking no ownership of inventory and receiving fees from suppliers for inventory management and fulfillment services. But this program is much more strategic than a simple third-party logistics provider.

As I noted earlier, the benefits of the CastleGate program accrue to the customer, to our suppliers and to Wayfair. Customers are delighted by the next-day or two-day delivery guarantee on the site, which is possible both due to the strategic locations of our warehouses that can reach a vast majority of the U.S. population with a one- or two-day groundshipping, and due to the way in which our warehouses are operated and integrated into the transportation network. Suppliers benefit from the dramatically increased sales volume for their products as a result of the next-day or two-day delivery guarantee. And they generally experience comparable warehousing cost and the inventory turns as they see in their existing warehouses.

Wayfair benefits not only from the incremental sales volume and increased customer satisfaction, but also from reduced transportation cost as we leverage the strategic locations of our warehouses and the volume of shipments coming from these warehouses. We also experienced reduced damage rates as we take more direct control and reduced the number of touch points for an order. After launching in 2015 and entering 2016 with approximately 1 million square feet of warehouse space, we are now operating approximately 3 million square feet of warehouse space across multiple facilities in Kentucky, Utah, and Southern California with additional facilities in New Jersey and the United Kingdom coming online this quarter.

While a small portion of our revenue flows through these warehouses today, it is ramping very quickly as we aggressively onboard suppliers and lease additional warehouse space to meet the backlog of demand from suppliers who are interested in participating. We are also beginning to take more direct control of our large-item delivery experience for products that are too bulky to be delivered through FedEx and UPS. Historically, this portion of our catalog represents 25% to 30% of our revenue. These very large deliveries have always been a customer pain point in our industry with long delivery times, high damage rates, and half-day long delivery windows.

We used to outsource the delivery of these very large items to a single national white glove company. But in 2011, we began directly contracting with linehaul carriers, pool point operators, and last-mile delivery agents in order to reduce cost and improve the customer experience. Just as we took steps in 2011 to leverage our scale and take more direct control, we are now taking further steps by optimizing our linehaul trucking and shifting to full truckloads, and operating our own pool points, cross docks and last-mile delivery facilities.

Similar to CastleGate, this allowed us to speed up delivery times for customers, reduce cost per order over time, and reduce touch points and damage rates. We also improved the service level we provided customers by incentivizing delivery personnel based on customer feedback and applying our technology expertise to enable convenient features, such as scheduling, delivery and cart upon checkout, which Steve will describe in more detail.

In October of 2015, we opened our first last-mile delivery operation as a Wayfair leased facility and operated by Wayfair employees. We focused on honing the operation, and now that we have made significant strides in customer experience and operational efficiency, we are working on adding to the service levels and rolling this out across the country. Today, we are operating five of our own last-mile delivery facilities, all in top 20 U.S. markets. And while it is still early days, the results are very encouraging with improving customer experience survey results. We intend to continue taking direct control of our linehaul trucking, pool points and cross docks and expect to have a total of eight metropolitan areas operating with our own last-mile delivery facilities by Q1 2017 and double that by the end of 2017.

I will now turn the call over to Steve to discuss some of the technological underpinnings of this expanded distribution network. Afterwards, I'll give an update on our international business and on some of the strategic investments we are making.

Steven K. Conine

Co-Chairman and Co-Founder

Thanks, Niraj, and good morning, everyone. Managing the complexities of our logistics infrastructure would not be possible without our custom-developed technology. Like all parts of our business, our logistics network was developed with technology and data at its core and with a focus on optimizing for the home category where products come in a wide range of sizes and shapes and can be bulkier, heavier and sometimes more fragile.

We think there's a lot of opportunity to take our technology and data and transform the large-item delivery experience for the customer. One recent new feature we added to our site is the ability for customers to schedule delivery of certain large items such as a bedroom set or a large patio set at the time of purchase upon checkout. Rather than placing an order, receiving an estimated ship date and then subsequently receiving an e-mail to schedule the delivery date a week or so later when the order is in transit, we allow customers to select their delivery date and time window right on the site as they complete their purchase.

While the customer sees a stress-free convenient way to pre-plan their delivery, behind the scenes, there's a lot more going on to enable this experience. Our technology takes a delivery location and product location to determine the eligibility and earliest possible delivery date, and then interfaces with the software of our last-mile delivery facilities to provide the available delivery windows to the customer. To improve the accuracy of the timeline, we leverage our ever-growing volume of big data around product ship times and supplier lead times. Customers then have the ability to adjust the delivery window to accommodate a change in their schedules from the site or from their mobile app.

We are also applying complex algorithms in our CastleGate program to enable our next-day or two-day delivery promise for our smaller parcel products, which can range in size from throw pillows to queen size upholstered headboards. Customers can filter their search results on our site to only shop products with the next-day or two-day delivery promise. For every product on our website that offers that promise, our technology needs to know the real-time CastleGate inventory, the customer delivery location, and the locations and utilization of the trucks in our network. We forecast the cubic feet availability per truck on a continuous basis and utilize data around short cut-offs for each day at all possible hubs.

Our algorithms predict how much space we need to reserve on trucks for our next-day or two-day guarantee, and how much other product going in the same direction can fit, which allows us to maximize our guarantee in coverage and our truck utilization and cost efficiency. Deep integration and partnership with FedEx and UPS are also required in order to optimize around carrier sort schedules to increase efficiencies and reduce cost and to bypass local carrier hubs and inject product directly in the forward carrier hubs. All of this data allows us to decide in real time what delivery promise we can make for each individual customer on every possible product.

Over time, our teams of engineers and data scientists will continue innovating to make our delivery experience faster and even more convenient for the customer. One product feature we are working on is real-time mobile app tracking of delivery trucks from Wayfair's last-mile facilities on their way to the customer's home. This would allow us to provide a shorter, more accurate delivery window and an Uber-like experience for the customer. This is just one of many examples of future product features our team of over 700 engineers is working on today to enhance the customer experience and generate more repeat purchases in the future.

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

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

Thanks, Steve. I'd now like to update you on the performance of our international business. As a reminder, we've operated sites in the UK since 2008 and Germany since 2009. In 2014 and 2015, we began laying additional groundwork in Europe to deepen the product catalog and build out the supply chain. We have served Canada through our U.S. sites since 2008. But in early 2016, we launched the Wayfair.ca site that is targeted specifically at the local Canadian market. With a solid offering in place in the UK and Canada, we began to ramp advertising spend in these two countries in 2016 to fuel customer acquisition and brand awareness.

I am pleased to report that our international business continued to show strong growth in Q2, reaching $54 million or 7% of total net revenue. Of total international growth, international Direct Retail growth was 170% year-over-year excluding the impact of the Australian business that we divested last year. While we continue to monitor the recent political events in the UK, our long-term vision for that business has not changed. Our German business is at an earlier stage as we deployed resources there later than in the UK. Our Canadian business benefits from the logistics infrastructure we have in the United States, and we are now able to serve approximately 40% of the Canadian population with a two-day delivery as we ship an average of five trucks each day from our Kentucky warehouses.

With a nearly $250 billion addressable market in Western Europe and a relatively underserved Canadian market, we continue to be excited about the market opportunity we have in the UK, Germany, and Canada and our ability to leverage the technology, ad spend, and logistics playbook we have developed in the U.S. over many years. You will hear more about this in a minute from Michael.

But I did want to talk a bit about some of the mid-term and long-term investments we are making in our international business and our transportation and logistics network and in our core business with new products and service offerings such as wedding registry and the home improvement categories. These initiatives do not contribute meaningfully to revenue today, but they do weigh on gross margin, they deleverage ad spend, and in particular, they increase OpEx as we hire employees to staff the teams dedicated to these initiatives. For example, there are approximately 1,000 people focused on ramping up these new initiatives that will provide meaningful revenue and profit generation in the future, but today, do not contribute meaningfully to revenue and certainly significantly hurt profit.

If you add up the compensation expense for these people and other operating expenses associated with these initiatives, such as rent versus new still heavily underutilized facilities. The run-rate annual cost is in excess of $100 million in operating expense, the vast majority of which is people. These initiatives also involve investment in the gross margin and ad spend lines, but we had delivered consistent gross margin and leverage in ad spend on an aggregate basis because of the strength of the core underlying U.S. business, which masks the drag on the overall P&L. If you add the gross margin investment and ad spend investment tied to these initiatives to the over $100 million in operating expense, the aggregate cost would be in excess of our total adjusted EBITDA losses.

Steve and I have said, since we went public, that substantial owner-operators will run the business in a way that continues to focus on the extraordinary long-term opportunity. What that means is that we will make the right long-term investments as long as they show progress. As an example, when we went public, we said we would invest heavily in ad spend and there will be leverage in ad spend as a percentage of revenue as we saw the payback on those new customers.

We have now delivered consistently on that since the beginning of 2015. Today, we feel the same way about our investments in our international business, our logistics infrastructure, and our new product and service offerings. We began most of these initiatives in 2015. At the end of the second quarter of 2016, we now feel that we have largely finished staffing them.

With the OpEx head count investment in place, we are excited about the future flow through of profitability in 2017 and beyond as revenue and contribution margin from these initiatives began to overtake the OpEx head count investment and flow through to the bottom line. We have never been more bullish about the long-term opportunity for our business and the potential benefits in 2016, 2017 and beyond with all of the initiatives we have underway.

I will now turn the call over to Michael.

Michael D. Fleisher
Chief Financial Officer

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

In Q2, our total net revenue increased 60% year-over-year to $786.9 million. As in recent quarters, this growth was driven by our Direct Retail business, which increased 71.6% over Q2 2015 to $755.7 million. Our other business, which primarily includes revenue from our retail partners, but also includes revenue from our small media business and CastleGate logistics program, decreased as expected 39.2% over Q2 2015 to $31.3 million as we continue to ramp down our retail partner business.

As Niraj mentioned, this quarter, the Direct Retail business increased $315 million versus Q3 last year. We are pleased to have maintained this momentum even as we reached a larger scale and increasingly comp off a larger base of revenue. This growth has been fueled by the U.S. where we believe we are taking between one-third and 40% of the U.S. online dollar growth in our categories and benefiting from higher brand awareness and repeat purchases.

As I've discussed in past quarters, providing guidance can be difficult in a high-growth business where you also need the consumer to show up every day and make purchases. This quarter we beat the top end of our revenue guidance, but not by as much as we have in previous quarters. One of our challenges in striking revenue guidance is forecasting next quarter's performance in the context of the dramatic sequential acceleration of growth from last year on top of which we are now comping.

As a reminder, the Direct Retail quarterly revenue comps in 2015 increased from 63% in Q1 to 81% in Q2 to 91% in Q3. Interestingly, if you look at the two-year stack for Direct Retail growth, which many of you do in your analyses and reports, it has been extraordinarily consistent with a range of 145% to 155% for the last six quarters. This quarter's Direct Retail growth of 71.6% is right in line with that range with a two-year stack of 152%. As I mentioned last quarter, we were not guiding for Q2 to create an outsized beat but rather to be prudent, particularly in light of an exceptionally strong June of 2015. These accelerating comps and the two-year stack, impact how we're thinking about Q3 and Q4 2016, which I'll describe more in a few minutes.

In Q2 2016, our earlier stage international business in Europe and Canada also exhibited strong growth. Though still relatively small, international Direct revenue increased 170% versus Q2 2015 excluding the impact of other revenue from our international retail partners and the impact of our Australian business that we divested last year. Our total net revenue growth remains incredibly high on an absolute basis. And we have been able to continue delivering this growth while maintaining compelling underlying unit economics.

We've consistently held gross margin in the mid-23%s to 24% since we went public. And the second quarter of 2016 represents the sixth quarter in a row where we have demonstrated year-over-year ad spend leverage despite the funding of substantial new advertising investments in our international business. Our gross profit for the quarter, which is net of all product costs, delivery, and fulfillment expenses, was $188.5 million or 24% of total net revenue and was slightly above our near-term target margin in the mid-23%s.

The remaining financials I'll share on a non-GAAP basis, excluding the impact of equity-based comp and related taxes, which totaled $11.3 million in Q2. For a reconciliation of GAAP to non-GAAP reporting, please refer to our earnings release on our Investor Relations website.

Customer service and merchant fees were 3.8% of net revenue for the quarter. Though there will be some quarterly fluctuations, we generally expect this expense to be variable. Advertising spend was $94.4 million in the quarter or 12% of net revenue compared to 12.5% in Q2 last year. This represents year-over-year ad spend leverage of 50 basis points in the quarter and was similar to the leverage we saw in Q1. Ad spend efficiencies are driven by our increasing mix of orders from repeat customers because we spend less on advertising to get our existing customers to buy again than to acquire a new customer.

The pace of our year-over-year ad spend leverage moderated in the first half of 2016 when compared to the pace of our ad spend leverage in 2015, because ad spend leverage in the U.S. is being partially offset by increasing advertising investments in Europe and Canada to fuel new customer acquisition. We expect the remainder of 2016 to show very moderate leverage year-over-year as we continue to invest in our international markets.

We added approximately 598,000 net new active customers this quarter, bringing LTM total active customer count to 6.7 million customers, up 65% year-over-year. LTM net revenue per active customer increased to $404, up 13.2% year-over-year. We also saw continued strong repeat purchase behavior with 58% of orders coming from repeat customers, a new high watermark, and LTM orders per active customer at 1.7, up from 1.67 a year ago.

Our merchandising, marketing and sales spend on a non-GAAP basis was $38.1 million or 4.8% of net revenue compared to $20.6 million or 4.2% of net revenue in Q2 last year. Non-GAAP operations, technology, and G&A expense was $64 million for the quarter or 8.1% of net revenue compared to $33.1 million or 6.7% of net revenue in Q2 2015. These two expense items consist primarily of head count expenses and their increase reflects the accelerated pace of hiring we had in the back half of 2015 and the first half of 2016 to keep up with revenue growth and to invest in the new initiatives Niraj discussed earlier.

In the second quarter, we added 794 net new employees for a total of 5,398 employees as of June 30, 2016, up 89% versus June last year. Of the 5,398 employees we now have, approximately 670 of them or 12% are located in Europe. The majority of the compensation expense for the new hires during the first half of 2016 resides in the merchandising, marketing and sales, and operations, technology, and G&A expense lines. As we noted on prior calls, the accelerated hiring we saw in the first half of 2016 has been a catch-up period as our recruiting team ramped up. We believe we are now well staffed for our strategic initiatives and expect to hire at a slower pace in the back half of the year.

Adjusted EBITDA for the quarter was negative $24.9 million or negative 3.2% of net revenue compared to our guidance of negative 3.2% to negative 3.6% and compared to negative $5 million or negative 1% of net revenue in the same quarter a year ago. The increase in our adjusted EBITDA loss margin versus Q2 last year was driven primarily by increased operating expense as a result of the hiring in the U.S. and Europe I just described, and to a lesser extent, by unutilized facilities costs as we ramp up our logistics infrastructure.

As I noted before, the unit economics of our business continue to remain strong, with solid gross margin, year-over-year ad spend leverage, increasing mix of orders from repeat customers, and increasing revenue per active customer in the second quarter, even as we grew active customer count to 6.7 million and continue to demonstrate extraordinarily high top line growth.

These strong underlying unit economics enable investments in several key strategic areas of our business, which initially drag on gross margin, deleverage ad spend, and in particular increase operating expenses. As Niraj noted, these investments are driving our overall EBITDA loss and are being offset by the continued success and contribution of the underlying U.S. business.

I would like to take a minute to elaborate on each one individually and how it impacts our financials. We described during our last call how our investment in our international business weighs significantly on our P&L in terms of gross margin, ad spend and OpEx.

In logistics, we believe our growing infrastructure will drive revenue uplift as we increase customer satisfaction and delight customers with a next-day or two-day delivery guarantee nationwide. But there is also a headwind to revenue as we take new sales tax nexus in the states where our warehouses, pool points, cross docks and delivery depots are now located. We have now taken nexus in nine states and 40% of our revenue in the second quarter was therefore subject to sales tax.

On the cost side, our efforts to ramp up our infrastructure should in the medium to longer term reduce costs per order as we benefit from more scale efficiencies. But there is some drag initially as we ramp volume to full efficiency levels and ramp up new warehouse space in step functions and bear the rent and occupancy cost of unutilized square footage.

For new product and service offerings, such as wedding registry, which we plan to launch later this year, we're incurring compensation expense as we hire new product, marketing and engineering personnel in advance of any revenue generation.

The goal of all of these investments is to return future incremental revenue growth, increase customer satisfaction and service levels, lower our costs per order, and therefore, lead to incremental profitability in the future. We will continue to closely monitor these investments as we always do to ensure that we are seeing the proper ROI and customer response.

Non-GAAP free cash flow for the quarter was negative $19.4 million based on net cash from operating activities of $24.9 million less capital expenditures of $44.3 million. As expected, CapEx spending was 5.6% of net revenue this quarter, driven by ongoing investments in our data centers and technology infrastructure and equipment purchases and improvements for leased warehouses within our expanding supply chain network.

While CapEx as a percentage of net revenue ran a bit higher this quarter, we continue to expect full-year 2016 CapEx to be approximately 4% of net revenue. It's also worth noting that our expanding supply chain network is primarily asset light; meaning, we lease warehouses and don't own any trucks as opposed to taking these assets on to our books. Our warehouse facilities are also optimized for bulky products that are often not conveyable; meaning, the level of equipment purchases and automation is relatively low on a per square foot basis, keeping CapEx costs lower.

Our inventory level was $17.4 million, or 0.6% of LTM sales, compared to 0.7% last quarter. Non-GAAP diluted net loss per share was negative $0.43, or negative $0.57 on a GAAP basis on 84.8 million weighted average common shares outstanding. As of June 30, 2016, we had approximately $353.5 million of cash, cash equivalents, and short- and long-term investments.

Now, let me give our guidance for the third quarter. As I mentioned earlier, we are comping off extraordinarily high Direct Retail growth from Q3 last year of 91%. And it's my goal to create guidance that is thoughtful and prudent. For Q3, we are forecasting Direct revenue between $790 million to $815 million, which year-over-year represents a revenue increase of $245 million to $270 million and a growth rate of 45% to 50%. These growth rates seem appropriate in light of the steep acceleration of our growth last year and a relatively consistent two-year stacked growth we have seen over the last year. As I've done in the past to provide transparency, please note that our quarter-to-date Direct Retail revenue growth is currently comping in the mid- to high-50%s.

We forecast Other revenue to be between $30 million to $35 million, down 39% to 29% year-over-year as we continue to deemphasize the retail partner portion of this business. This equates to total net revenue of $820 million to $850 million.

We forecast adjusted EBITDA margin of negative 4.25% to negative 4.75% for Q3. Our continued losses at these levels are driven primarily by our ongoing aggressive investment in our international business and the other OpEx head count and related investments Niraj and I have described earlier on the call. We are now caught up on our hiring to staff these many initiatives, and that head count in both our international business and U.S. business is a critical investment in the future long-term growth of Wayfair.

We have always said that we will make the investments necessary to take advantage of the long-term opportunity created by the significant accelerating shift online in our category. Small movements in our revenue forecast have an outsized impact on our EBITDA margins as we are not rescaling our investments, which are all mid- to longer-term in nature.

We do expect to continue showing good unit economics with gross margin continuing in the mid-23%s, solid contribution margin and some ad spend leverage, albeit much smaller due to the continued ramp of our international investments.

OpEx cost as a percentage of net revenue will continue to rise in Q3 with the full run rate impact of our first half catch-up hiring, and then should show good sequential leverage in Q4. We continue to target breakeven adjusted EBITDA in Q4, so this will be highly dependent on the level of revenue growth we guide next quarter for Q4. Stating the obvious, since we are targeting breakeven and our cost structure, based on our investments, is somewhat set in place, small increments of revenue growth have the potential to drive Q4 either just over or under the breakeven level.

We will update you on this next quarter, but nothing has changed in both our long-term focus on making the right investments in the business and our desire to drive the business to free cash flow positive and EBITDA breakeven and profitability in the near- to mid-term.

For modeling purposes for Q3 2016, please assume equity-based compensation and related tax expense of $15.7 million, average weighted shares outstanding of 85.1 million, and depreciation and amortization of approximately $16 million.

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

Niraj S. Shah

Chief Executive Officer, Co-Chairman and Co-Founder

Thanks, Michael. Before we wrap up, I just want to reiterate one concept that Michael mentioned. We're running the business today with very consistent gross margins and contribution margins. With an approximate contribution margin on incremental revenue of 20%, we have used these incremental contribution dollars, which are large because of our large dollar growth, to make the important investments that we've been discussing today in the international markets, in our distribution and logistics network, and in new product and service offerings.

The assets, primarily in the form people and real estate, to drive those initiatives are largely in place now. And our continued strong growth at massive scale will continue to deliver large contribution dollar flow-through and create leverage, particularly in the OpEx lines, as we move into Q4 and 2017.

I could not be more excited about how our business is resonating with customers. As we've always done, we will continue to make the right investments to deliver an exceptional experience across the board to our growing audience of new and repeating Wayfair customers. Now, having our teams fully staffed against these initiatives, we are excited to execute on our plans and deliver for our customers and drive solid financial performance.

We'd now be happy to take your questions. So I will turn the call over to the operator.

QUESTION AND ANSWER SECTION

Operator: Thank you. Ladies and gentlemen, we will now conduct the question-and-answer session. [Operator Instructions] Your first question comes from the line of Neely Tamminga with Piper Jaffray. Your line is open.

Kayla R. Wesser
Piper Jaffray & Co. (Broker)

Q

Good morning. This is Kayla Wesser on for Neely. As we think about new customer acquisition, just wondering if you could talk more about some of your new strategies like registry and loyalty and more specifically in terms of timing of rollout and maybe key attributes of the programs? And any sense on if these programs are being requested by your current customers? Thanks.

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

A

Thanks, Kayla. This is Niraj. So in terms of the new things you mentioned, so kind of few different things in there. Our loyalty program, we revamped that with the launch of the private label credit card last fall in August, September timeframe of 2015, and that's gotten off to a really nice start, and so we'll give you an update on that in the near future. But that continues to ramp and we've been working on a version two of that or – not a revamp but additional set of things that we'll roll out pretty soon.

In terms of the registry, we did a soft launch for that. It's actually coming up shortly and that'll fully launch in the early fall which I think we've mentioned. And then a lot of the things we're doing for customers to allow them to basically grow their share of wallet with us are things that we've mentioned in the past around seasonal décor, decorative accents, the home improvement categories. And those are initiatives we've been working on for a while that kind of continue to roll out as we speak.

So all these things are in play now and one of the things we tried to mention on the call was that all of these efforts were started in 2015 or before. And so we've been at these for a while. And what's exciting about the time period now is that they're actually now all starting to reach market. So we expect to see exciting things come from them as we move forward.

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

A

Okay. I think we should...

Operator: Your next question comes...

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

A

Yes.

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

Seth M. Basham
Wedbush Securities, Inc.

Q

Thanks a lot and good morning.

Steven K. Conine
Co-Chairman and Co-Founder

A

Hey, Seth.

Seth M. Basham
Wedbush Securities, Inc.

Q

My question is around orders per active customer. We saw that metric increase on an LTM basis, but year-over-year and quarter, it was down. As you invest in all of these initiatives to improve share of wallet, as you just mentioned, how are you thinking about orders per active customer going forward?

Steven K. Conine
Co-Chairman and Co-Founder

A

Yes. Thank you, Seth. We would expect orders per active customer over time to go up. The main metric we really look at is the dollars per active customer. But the two are pretty closely related because our strategy is not to prioritize AOV over orders. It's really to prioritize the total customer share of wallet, which really means you need to drive orders.

So the expectation is that you should see that number rise. And as you know, that's a slow number to move, either up or down, because of the way it lags the current events. And so our expectation is basically that will continue to go up, albeit slowly.

Seth M. Basham
Wedbush Securities, Inc.

Q

Okay. That's helpful. As it relates to AOV specifically, we saw a really strong growth once again this quarter. Can you give us a sense of the drivers behind that improvement and how we should think about AOV going forward?

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

A

Yes. So the thing about AOV is it's really an outcome. And so AOV gets driven by a few different things, but the primary thing AOV gets driven by is basically category mix shift. And so I mentioned seasonal décor and decorative accents, as those scale and take some share from the total, they will pull down AOV. With the home improvement categories, which are some of the earlier categories of the emerging ones that have started to grow will pull up AOV. And then you have some things like our international business, which, in general, today would pull down AOV.

So you have this mix shift of different businesses and the mix shift of categories within businesses that makes that number move around. This is a little bit of why we talk about the average orders per customer a minute ago, AOV times that is the dollars per customer per year, and that's kind of why I keep going back to the dollars per customer per year metric.

Seth M. Basham
Wedbush Securities, Inc.

Q

Understood. Thank you very much and good luck.

Steven K. Conine
Co-Chairman and Co-Founder

A

Thanks, Seth.

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

Matthew J. Fassler
Goldman Sachs & Co.

Q

Thanks a lot, and good morning. Couple of questions. First of all, when you talk about your two-year stack for Direct, it has in fact been quite consistent, 156% I believe in Q1, 152% in Q2. At the high end of your range or I guess the entirety of your range for Direct would imply a little bit of deceleration in this to your stacks. So how should we think about that in terms of the momentum in the underlying business and what might be transpiring beyond compares?

Michael D. Fleisher
Chief Financial Officer

A

Yes. Matt, I think that's just us being thoughtful and prudent. Obviously, it's really tough when you're trying to forecast against what was a massive acceleration in growth rate last year on an already big base. And so obviously, we have the data where we're at quarter-to-date, and as I've said, that's in the mid- to high-50%s. But at the same time, I got to strike guidance and knowing that I still got a big chunk of the quarter left in front of me, and I'm working against an increasingly tough comp as the revenue accelerated throughout the quarter. So it's really just trying to be thoughtful about guidance setting within that context.

Matthew J. Fassler
Goldman Sachs & Co.

Q

Got it. And then second question. You spoke about the investments you made in people. You talked about the initiatives that you're engaging in, all of which were thoughtful. Do you think of these as essentially revenue driving over time, or are they, in essence, revenue preserving or franchise enhancing in that way? So do you see a return on, I guess, those operating expense dollars the same way you've very closely measured and delivered on returns on our ad expense dollars?

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

A

Yes. Thanks, Matt. This is Niraj. I would tell you to think about them as revenue driving. So the way to think about them is you have things like new categories or offerings like registry and home improvement, which are easier to see how those are revenue driving or internationally easier to see as revenue driving. But when you think about the logistics investments, basically, the primarily thing they do is they improve lifetime value and they drive up conversion rate. And both of those are very revenue driving activities.

And so I think you could think of everything we're doing as revenue driving. And the thing I would say is the difference between like preserving enterprise value or defensive moves and offensive moves are largely a function of time, in the sense that if you think about what the customer wants and you're very aggressive about it early, you effectively not only get the benefit of the customer reaction to that, which is revenue-driving, but you build a moat that then forces others to fall behind. They then do it to try to preserve their revenue. They try to copy you, but it's very hard to catch up. So the nuance between the two I think is maybe slightly smaller than you might think at first blush.

Matthew J. Fassler
Goldman Sachs & Co.

Q

Got it. Thank you so much.

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

A

Thanks, Matt.

Operator: Your next question comes from the line of Oli Wintermantel with Evercore ISI. Your line is open.

Oliver Wintermantel
Evercore ISI

Q

Yes. Good morning, guys. I had a question regarding the EBITDA guidance for the next quarter. It looks like it's a bigger step down in the third quarter year-over-year versus what we saw just in the second quarter. Can you maybe give us some insight into what drives that? Is that more on the international side, more on the U.S. side or what is driving it?

Michael D. Fleisher
Chief Financial Officer

A

Yes. Hey, Oli. It's Michael. I would say it's really driven by both, but primarily, as a starting point, is we continued international investment. As we noted on the call, we have 670 people in Europe now. Obviously, that's a substantial investment against what is still a small albeit very fast and increasingly growing revenue base. So I think piece number in terms of thinking about where our losses are coming from is certainly the international business.

The second is, as Niraj spoke about on the call, we are making some substantial investments in our distribution and logistics infrastructure here in the U.S., and that has a cost as well, as well as all these new areas that we're investing in, the home improvement categories, registry, et cetera. And so, I think the place you're going to see it is you're going to see it increase in the OpEx line, and particularly, you're going to continue to see growth on a dollar basis from Q2 to Q3 in the OpEx line, and then you'll really start to see the leverage in that line in Q4 as we sort of slow the pace of hiring in the back half of the year when we're really catching up and more aggressively hiring folks in all of those categories in the first half of the year. So I think you'll see us effectively deleverage in Q3 and then leverage in Q4.

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

A

If I can just chime in for a minute on that question, Oli. So just a couple points. So if you look at the OTG&A and MMS lines added together, which are basically the OpEx lines really driven by head count in particular, you see this quarter it's at 11.4% of revenue. If you look at a year ago, it was 9.4% of revenue. So, it went up 200 basis points.

Now if you look at what happened last year, you see in Q3 it actually went down from 9.4% to 8.6%, so it went down 80 basis points. And at that time, we mentioned that hiring was slower than we're hoping to have it, and we talked a lot about, well, do you think you'll be able to hire people you want? We said, we will. We just didn't have the recruiting infrastructure in place, da-da-da. And then a couple of quarters later – a quarter later, we mentioned that we now had an infrastructure in place.

Well, the point is what you see now is you see that we've hired all these folks. This quarter we hired net new 794 people. And so, we've hired all these folks. You see that line deleverage, and what it's basically reflecting is that we've hired OpEx folks at a rate faster than revenues hired, but it's not against the revenue, it's against the initiatives which were basically harbingers of future revenue.

So, what will happen is that that line which in the third quarter of last year was 8.6% went down from the second quarter. This year now we've hired all these folks, but they're now on payroll. It won't – now they're going to be paid for a full quarter, right, that it's not going to go down right away. It'll go down now over time as the revenue continues to grow. But to Michael's point, we're not continuing the ramp of hiring. So, it goes down not just because it's against the revenue but also because the rate of hiring slows.

So, these initiatives which are really about the future, which I mentioned $100 million for the OpEx, OpEx is really the people and some of the rent. But these investments have a huge deleveraging effect on gross margin and on ad cost. And if you add it all of that together, the cost from these initiatives is very, very large.

If you go down to this list of a little over a dozen initiatives, they're actually very, very substantive. And what they'll do from a competitive advantage standpoint, what they'll do for future revenue, what they'll do for lifetime value, all of these things. So, we're thrilled about them. And what you're seeing is the consequence of sort of the full cost of all of them now hitting and you're not seeing the benefit of many of them yet; however, enough time has elapsed, and you're seeing that they're now starting to roll out.

So, we're very excited about the kind of near to mid future. But there's kind of big opportunities here. When you think about, as Michael mentioned the vast majority of this is internationally, you think about the magnitude of that effort. And then after that in scale, you think about the logistics network and then magnitude of that. And then you think certainly about some of these category extensions, it does add up.

Oliver Wintermantel
Evercore ISI
Q

That's helpful. Thanks. And then just quickly on the gross margin line, it was 23.8% in the third and fourth quarter, that's right in line with your near-term guidance. Is that a prudent assumption for the second half then as well?

Michael D. Fleisher
Chief Financial Officer
A

Yeah. I think we continue to target mid-23%s. And we sort of said mid-23%s to 24%. We came in a little high this quarter. But also remember, Q4 is the holiday period; typically a place where sort of everyone gets sharper on price, and therefore margin tightens up.

Oliver Wintermantel
Evercore ISI
Q

Got it. Thanks very much.

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

John Blackledge
Cowen & Co. LLC

Q

Great. Thank you. Just a couple of questions. So, for the CastleGate initiative, could you discuss the conversion rates for items that are available for delivery in one or two days versus comparable items that are available at later delivery dates? And then what percent of small parcel inventory is available in one to two-day delivery at this point? And then I have a follow-up.

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

A

Sure. So, on the conversion rate lift, that's not something we publicly disclose, but there is a meaningful conversion rate lift when we promised that fast delivery on these larger bulkier items. In terms of the percent of our business that is going through the fast delivery network, I would basically describe it today as high single-digit percentage of our revenue is flowing through that network. And we believe we're now in a position to ramp it quite quickly.

John Blackledge
Cowen & Co. LLC

Q

Okay. That's great. And just a quick follow-up. Michael, could give us a sense of the second quarter EBITDA in the U.S. and international and also ad expense in the U.S. and international, and when will you break out U.S. and international results? Thank you.

Michael D. Fleisher
Chief Financial Officer

A

Yeah. We did see greater ad leverage in the U.S. We're not giving the specific details because we're not going to sort of keep doing that, but we did see greater ad leverage in the U.S., obviously offset by the investment in the international business. I think using the back of the envelope math we've given everybody in previous quarters, you can look at almost all of the losses this quarter as being tied to the international business.

And it's not hard to get there when you sort of add in the operating costs of that business plus the lower gross margin and lower contribution margin and less than lower – higher ad spend. And in terms of sort of breaking out, I think we recognize that everybody has a great interest in sort of better understanding the international, U.S. split. At the same time, it still represents 7% of the business albeit one that's growing very quickly. And so, we're carefully considering sort of what's the right time and the right format to give additional detail.

John Blackledge
Cowen & Co. LLC

Q

Thank you.

Michael D. Fleisher
Chief Financial Officer

A

Thanks, John.

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

Michael Graham
Canaccord Genuity, Inc.

Q

Hi. Thank you. The old framework that we had been discussing around margin progression in the out years was sort of a couple of hundred basis points of expansion per year. You've got a lot of investing going on. I'm wondering if you have any comment on that, just philosophically. You took a step backwards in profitability in Q3. Would you be willing to do that in the future?

And then related to that, the two things that could extend this framework of investing beyond what you're talking about are more product and geographies beyond Europe. And I'm just wondering if you can comment on how you're thinking about those possibilities.

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

A

Sure. Look, let me start with the expansion of categories and geographies. In categories, we're very focused on just being a home player. So when we talk about our categories, we talk about furniture and décor, and we talk about the finished parts of home improvement, which are like plumbing and lighting, flooring. These are the categories that our consumer, that she's picking herself, not things for the builder. We talk about housewares and kitchen. So, we're not terribly interested in expanding that list.

So, if you think about the ones that we've talked about that we're pushing into, they're effectively just fleshing out that list, but we're not really looking to change that list, if that makes sense. So, don't look forward to us entering media or apparel or these adjacent categories, we're very focused on home and within the construct of what I just described.

In terms of geographies, we're very much focused on the four countries we operate in today. So, the United States and Canada, North America, and in Europe, it's the UK and Germany. And those are very large markets. They have a lot of opportunity. And as they continue to scale up, it'll open up other geographic opportunities which are adjacent. But, to be honest right now, our focus is entirely on those four geographies. So, I would think about kind of the near mid-term oriented around that construct where we believe there's a huge amount of opportunity in those geographies with the home offering, and that's absolutely what we're focused on.

In terms of the margin expansion question that you started with, the way I would describe it – what I believe that we've always said is that we're very focused on getting to free cash flow positive, which is the way we operate the business for the first decade, which is why Steve and I were able to effectively own the portion we own today. And we believe that's a really good way to function.

And so, the fact that over the last few years we've raised a lot of investment capital to build the brand, and we're operating at a loss, that's not a place we really want to be. And so, we're very focused on getting back to free cash flow positive, and EBITDA positive, and self-funding our growth.

That said, we're very interested in being very ambitious and capturing what we believe to be a very large opportunity that we don't believe will last forever. So, in that sense, anything that is prudent in the confines of the strategy we have around the categories we're interested, the markets we're interested in, we're certainly going to pursue. And so, our ideal strategy is to pursue that while generating our own investment capital and not having to do that by raising outside capital, which obviously is very dilutive.

So, in terms of the rate of margin expansion, what we said is, we're very focused on getting to this free cash flow positive, this EBITDA positive place. And we expect that the expansion of margin will continue because the amount of flow through contribution margin exceeds our ability to invest it. But we said that while we're very focused on getting back to where we're self-funding, we are less focused on the time period it takes to get from there to the target long-term EBITDA because we expect that to be impacted by investment opportunities, some of which are hard to predict the timing of which today.

But despite that, we don't expect to be able to spend the flow-through EBITDA on wise investments so we expect it to continue to flow through, thus increasing our EBITDA percentage, which is why in Q1 of 2014, we're at negative 7% EBITDA, and even with this head count ramp that we just talked about, which took us down on an EBITDA percentage, we think we're going to swim back up from that fairly quickly in the not-too-distant future. So, that's the way I would kind of define it.

When you talk about, of course, margin expansion, we always talked about private label ramping, which is something that's ramping nicely. We talked about transportation cost efficiencies, and our logistics network is a driver of that. We just gave you a kind of a pretty good update on that. And we talked about buying power from volume. And even there were some comments about how our growth is decelerating, and we are comping off 90% growth.

Frankly, growth will decelerate and frankly at the rate we're growing at, at the scale we're growing at, growth will decelerate. Just to remind you, the market is only growing 12%, 15%-something, depending on what you believe online is growing at. The overall market is only growing a few percent. We think even if this growth "decelerates," we're going to still be growing at a very excess growth rate to continue to take significant share. And while preserving that flow-through contribution margin of 20%. So, I know that's a longer answer than you're looking for, but I was kind of hoping to kind of tie all together.

Michael Graham
Canaccord Genuity, Inc.

Q

Yeah. That was exactly what I was looking for. Thank you, Niraj.

Steven K. Conine
Co-Chairman and Co-Founder

A

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

Operator: Certainly. Your last question comes from the line of Chris Horvers with JPMorgan. Your line is open.

Christopher Michael Horvers
JPMorgan Securities LLC

Q

Thanks. Good morning, guys.

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

A

Hello, Chris.

Christopher Michael Horvers
JPMorgan Securities LLC

Q

I wanted to understand, as you pivot back to the two-year stack in the different businesses, can you talk about what the experience has been in the U.S. And then is there a U.S. only? And then is there a point in time that you can look out to say international business is x percent of revenues today. But once it gets to a certain scale that that's actually been the two-year stack to a higher level. Thanks.

Michael D. Fleisher
Chief Financial Officer

A

Yeah. Chris, I think, we obviously we've given you the international growth. It's obviously on a small base. It was 170% that we've tried to do the math to exclude the partner business as well as the Australian business that we divested just so you have the sort of clean math, which you'll need because that detail isn't in the Q. But it's obviously still a small piece of the whole, right. The U.S. business continues to chug along at a sort of a substantial growth rate because it's the vast, vast majority of the business.

I do think that at some point in time, that business has very long legs, right, where we're tiny compared to the market opportunity. You'll remember roundly the Western European market is $250 billion like the U.S. business. And so there's a ton of room to go versus the $50 million business we have there today.

So, I think the opportunities are going to scale and then be a meaningful sort of accelerant and growth contributor exists. But it's got a long way to go to sort of get to the scale where it can outstrip what continues to be extraordinary growth on a massive base of the U.S. business.

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

A

Yeah. I think that's a good summary of it. We mentioned that the direct international business grew 170% in the quarter and despite that, it ticked up to 7% of sales. So, you can kind of see the relative size of it it's going to be a drag.

I think the way to think about is if you think about these things independently, and I know you guys have said, hey, at some point can you give us the full segmented financials and what have you and obviously that would be helpful, and we're aware of that. You have these different exciting growth things going on. You've got this international business where you came and treat it as one thing, when you think about Canada separate from the UK, separate from Germany. In the U.S., you have Wayfair.com which is our dominant brand in the U.S., but you have other brands, Joss & Main, and AllModern, and they're all on different growth trajectories.

And so, there's lots of things going that all add together to give you this aggregate growth number. And that's why you can see these different trends in terms of how it's going to play out over time, being perhaps a little more volatile than if you're kind of steadily growing a few percent a year off the expansion of new units being added that are fairly predictable.

But the opportunity is I think much larger because of the disruptive nature of the Internet and the fact that the speed at which share is changing hands. So, we're certainly very focused on that. We obviously run the business in a very granular way to make sure that each individual effort and then the funding we're giving it is paying off. And then when you add it up, you have these patterns that, to be fair are kind of hard from the data you have, I would say, to kind of model out precisely. But there's certainly very exciting growth things underway that we expect to see flow into results over time.

Christopher Michael Horvers
JPMorgan Securities LLC

Q

Thank you.

Steven K. Conine
Co-Chairman and Co-Founder

Great. Thanks everybody for joining the call today, and we look forward to talking to you next quarter.

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

Bye guys.

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