Wayfair, Inc.

First Quarter 2017 Earnings Release and Conference Call

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CORPORATE PARTICIPANTS

Julia B. Donnelly, *Director of Strategic Finance and 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

Peter Keith, *Piper Jaffray & Company*

Seth Basham, *Wedbush Securities, Inc.*

John Blackledge, *Cowen & Company*

Matthew Fassler, *Goldman Sachs & Company*

Christopher Horvers, *J.P. Morgan Securities*

Oliver Wintermantel, *Evercore ISI*

Michael Graham, *Canaccord Genuity, Inc.*

PRESENTATION

Operator:

Good morning. My name is Krista and I will be your Conference Operator today. At this time, I would like to welcome everyone to the Wayfair Q1 2017 Earnings Release and Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. If you would like to ask a question during 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.

Julia Donnelly, Head of Investor Relations, you may begin your conference.

Julia B. Donnelly:

Good morning and thank you for joining us. Today, we will review our first quarter 2017 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 second quarter of 2017. 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 2016, and our subsequent SEC filings identify certain factors that could cause the Company's actual results to differ materially from those projected in any forward-looking statements made today.

Except as required by law, we undertake no 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 will be 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 us this morning. We are pleased to share our Q1 results with you today. We are thrilled about the momentum we are seeing in our business right now, both in terms of revenue growth and profitability but also in terms of the progress we are making along the key strategic initiatives we've been investing in for about two years.

Steve and I have watched this business go through many different stages of its growth. After adding over 1,800 net new employees over the course of 2016, we have been especially pleased to see how they and the initiatives they are driving have hit their stride. The ramp up curve is always painful when you hit a spike in hiring, but now, after fully integrating those 1,800 new hires, we feel like we've continued to assemble a truly impressive team that is firing on all cylinders.

In Q1 we generated $940 million in Direct Retail net revenue, up 32% year-over-year and $961 million in total net revenue, up 29% year-over-year. First, I'd like to focus on our U.S. business, which generated $838 million in Direct Retail net revenue, up 25% year-over-year and $4 million of positive Adjusted EBITDA in Q1. We have several major initiatives in the U.S., as we continue to improve our overall offering to deliver an exceptional experience for our customer. One such initiative was taking some of those 1,800 new hires in 2016 and staffing up dedicated teams to go after categories in our total addressable market where we are smaller relative to our market potential, such as Home Improvement, Seasonal Décor, Housewares, Wedding Registry, Mattresses, and Decorative Accents. We're starting to see traction in these categories as we develop supply relationships, enhance visual merchandising, and in some cases, develop specialized sales teams to support these particular categories.

One example of an area where we are seeing great progress is the Home Improvement category, by which we mean the finished areas of plumbing, lighting, flooring, and hardware. Most of the online and offline market for Home Improvement today is serviced in poorly merchandised settings that are more oriented for male customers. We believe that the same customers we have shopping our Wayfair sites, who are primarily female, are also the one selecting which showerhead, wall sconce, kitchen backsplash tile, and bathroom vanity they want in their house. We are successfully building a Home Improvement business because she wants the same vast selection to choose from and the same great visual merchandising that we deliver for our other categories.

Another effort on the merchandising front is our House Brands program. We used to refer to this as our Private Label program, but, in reality, it is not a traditional private label approach. Many retailers approach private label by dis-intermediating their suppliers and manufacturing product directly in order to pick up a few points of margin on the inventory they hold. Instead, we work with our suppliers to put their products, particularly their newer introductions, into one of our 40-plus different house brands. Consistent with our inventory light model, we do not design the products nor do we carry the inventory.

Each house brand includes products from multiple suppliers, but has a consistent style and price range. Examples include Andover Mills, an entry price point traditional look; Wade Logan, a moderately priced contemporary look; and Lark Manor, a moderately priced cottage look. By grouping products together and bringing them to life via visual imagery, we've made it easier for customers to be inspired and identify items on the site that fit her personal taste. This is incredibly important in the home category where the customer often does not know what she is looking for until she sees it.

Search does not drive our category, amazing visual imagery and discovery do. Increasingly, we are able to use our library of 3D product models to digitally render 2D lifestyle imagery in support of these house brands at a substantial discount to the cost of using photo studios. In addition to this proprietary imagery, we also lean in more heavily with our House Brands with on-site and e-mail promotions and customer reviews.

The last time we provided an update on our house brands penetration was during the Q3 2016 earnings call. We noted at the time that it represented one-third of Wayfair.com revenue, up from only a very small percentage of revenue about a year prior. For Q1 2017, house brands grew to approximately 45% of Wayfair.com revenue and we expect that penetration to increase further as we continue to add a lot of products to our house brands and deliver more visually inspiring imagery to bring it to life for our customers.

In addition to Wayfair.com, we also have four other sites in the United States: Joss & Main, AllModern, Birch Lane, and DwellStudio. Wayfair.com represents the vast majority of our revenue, which is why we tend to focus on it during these calls. But we thought this quarter it would be a good time to refresh everyone on our retail brand strategy, as well as introduce you to our newest site, Perigold.

We think of Joss, AllModern, Birch, and Dwell as lifestyle brands that provide a more curated assortment to customers who prefer a particular style. Where Wayfair.com is focused on providing exhaustive selection across all styles and price points, the lifestyle brands are focused on providing a curated assortment within one particular style and a narrower band of price point. For example, Joss & Maine is focused on more fashion-forward styles, AllModern is focused on modern, Birch Lane is focused on classic American, and DwellStudio is focused on mid-century inspired contemporary. Where Wayfair.com offers millions of SKUs and primarily attracts mass-market customers, these lifestyle brands offer tens of thousands of SKUs and typically attract customers with a household income of over $100,000. With tens of thousands of SKUs, our lifestyle brands provide a more curated assortment than Wayfair.com, but still offer far more selection than traditional lifestyle brand retailers.

We know customers shop from multiple stores when they buy items for their home and we know some customers prefer to shop in a more curated setting. Our lifestyle brands allow us to service these additional segments of the market beyond Wayfair.com. As a reminder, Joss's history when it was founded in 2011 was as a flash sale site, but beginning in early 2016, it transitioned to more of an everyday catalog and it has seen strong growth under this new model.

A few weeks ago, we soft-launched our newest site, Perigold, a retail brand that targets the high-end luxury segment of the market. Price points on Perigold are significantly higher than what you would typically find on Wayfair.com or the lifestyle brands we just discussed. Paragould essentially picks up where our current offering ends, and then runs all the way through the luxury segment. We know some affluent customers occasionally shop at Wayfair for their second home, their son or daughter's college dorm room, or their child's playroom, but they wouldn't necessarily think about coming to Wayfair for their master bedroom, living room, or dining room. With Perigold, we will have a site that can service that type of demand.

Our goal is to create a customer experience with Perigold that is superior to the alternatives that high-end consumers and interior designers have today. Today, those customers are limited to high-end regional brick-and-mortar stores, specialty retailers with limited selection, and design centers that regular customers can't even step foot in unless they're accompanied by an interior designer. There's a misperception out there that online penetration in the high-end luxury segment of the market lags that of the mass-market. If you look at certain luxury competitors, like design centers, it is certainly true that their models have remained stubbornly brick-and-mortar. However, if you add up the online businesses for other specialty retailers, you quickly come up with several billion dollars worth of higher-end product that is already online today. With the vast selection of high quality product across various styles, great visual merchandising, our logistics network, and great customer service, we think we'll be able to provide an experience that's superior to what is available, both online and offline in this segment of the market today.

Notably, we were able to stand up to Perigold’s site and brand very quickly. We already have an impressive set of top supplier brands at the soft launch of Paragould, with many more set to join. Many of these suppliers who are participating in Perigold are ones with whom we already had a relationship, often built over many years as they participated in our interior design or trade program. The technology and logistics back end for Perigold is the same one that we use for all of our other sites, so from the time we said go, it took only 100 days until the soft launch.

As the offering comes together, we will then begin marketing Perigold with consumers and trade customers. As we've done with Joss, AllModern, Birch, and Dwell, the marketing efforts around Perigold will leverage our traditional marketing playbook and infrastructure. We do not expect the advertising spend for Perigold to impact total advertising spend as a percentage of revenue for 2017.

We are still in a very early soft launch phase and have not yet started to market to customers. We're continuing to add more suppliers every week and we are further developing this site. We are excited to see how consumers and interior designers take to this new brand as it develops over the next few quarters, and we will report back when it is more fully launched.

I've provided a deep dive on our CastleGate and Wayfair delivery network, or WDN, logistics initiatives on our last earnings call, so this time we will just give you a brief update. As we've noted before, the initial rollout phase of our logistics network really began in 2016 when we ramped up from approximately 1 million square feet at the beginning of 2016 to approximately 5 million square feet at the end of 2016. As of March 31, we are now at approximately 6 million square feet, driven largely by the launch of our CastleGate and last mile facility in Atlanta, Georgia.

The addition of Atlanta brings the number of Wayfair-controlled last mile facilities to seven as of March 31. In the second quarter, we are adding additional CastleGate square footage in Southern California, as well as a handful of last mile delivery facilities, bringing us to approximately 7 million square feet-plus at the end of Q2 across the entire network. After that point, our initial rollout of large CastleGate facilities will be complete and we will add additional capacity incrementally as existing facilities become full. As we noted last quarter, our plan is by the end of 2017 to have approximately 90% of our large parcel shipments flowing through the Wayfair-controlled middle mile and 15 to 20 Wayfair-controlled last mile facilities covering approximately 60% of the U.S. population.

As a reminder, these logistics initiatives are initially an expense drag on the P&L as they ramp up, but over time they reduce the transportation costs and damage rate per order as these networks scale. On the revenue side, these networks also increase sales conversion by enabling fast delivery speeds and materially increasing customer satisfaction and NPS with large parcel deliveries.

Now, I'd like to touch on our international business in Canada, the United Kingdom, and Germany. We believe the market opportunity across Canada and Europe is approximately $300 billion, roughly the same size of the U.S. addressable market alone. Our 15 years of operating experience in the United States provides us with a strong foundation to penetrate these markets, but with a clear recognition that every market has its own unique attributes. The technology infrastructure, the ad tech stack, the marketing playbook, and the experience building and operating logistics networks and customer service centers are all skill sets we bring to the table and can leverage in these new geographies.

On the supply side, we have the benefit of local Canadian and European suppliers who have seen our success in the U.S. and are, therefore, excited to engage with us. We also have deep, scaled U.S. supplier relationships that we can bring to these new countries via our CastleGate U.K. warehouse, thereby opening up new markets for our suppliers and allowing us to fill gaps in our International product catalog, with product where our wholesale pricing is more attractive due to our scale.

At the same time, we know that local customization is important and that in some cases the strategy that worked in the U.S. may not work in other markets. For example, marketing messages resonate differently in each geography, promotional calendars need to be reoriented around local holidays, and in Canada we have even recently launched a French version of the site to cater to our Québec customers. Overall, we are very pleased with the trajectory of the International business with International Direct Retail growing 163% year-over-year in Q1.

As we emphasized during the last few calls, we are focused on three key investment areas to drive the long-term growth and profitability of Wayfair: building out our International business, investing in our proprietary logistics networks, and growing our teams in the U.S. to further penetrate various categories in our total addressable market. These key areas in which we are investing have not changed as we remain dedicated to delivering the best customer experience possible within the Home category. Within approximately $600 billion market opportunity across North America and Europe, we feel these investments are worthwhile, even though they weigh some on our P&L today.

Now, I'll turn the call over to Steve who will update you on some of the ways we're using technology to serve the customer and serve our suppliers.

Steve Conine:

Thanks, Niraj. One of the unique characteristics of Wayfair has always been our hybrid business model. We offer the customer a high-quality first-party retailer experience when it comes to our brand, website, customer service, shipping, delivery, and returns. We also work with over 10,000 suppliers and integrate with them on the back end in order to provide the vast selection more typical of a third-party marketplace. We think this hybrid model delivers the best experience possible to the customer, but requires a lot of work on our end to have it all work seamlessly.

In order to offer the optimal browse and search experience for our customer, we need a lot of details about the products available for sale on our sites. This requires us to get product images and detailed product attributes from our suppliers, often above and beyond what other retailers they work with might require. Our customers are discerning and want to understand exactly what they're buying, particularly when they're not able to view the product in person before buying. So, we want to be able to tell her details such as whether the drawers on the TV stand she is looking at are soft close or whether her six-inch plastic storage bin will fit under the bed frame she is looking to buy. We know these types of specific details are helpful to customers, but they do create more work for our suppliers as they are introducing new products for us to sell on our sites.

Our supplier extranet helps us manage our relationships with over 10,000 suppliers every hour of every day. It is a one-stop shop for suppliers to manage their orders, add new products, and manage promotional events with Wayfair. Over the last several quarters, we have invested deeper in our extranet to expand its capabilities, provide a more seamless experience for our suppliers, and to provide tools that help our suppliers grow and scale their business with Wayfair. One example is a recent change to our extranet that allows suppliers to upload new products faster. We still capture the necessary product attributes that are so valuable to the customer, like where those TV stands drawers are soft close, but we have simplified it from a two-step process that used to require 10 to 12 days before the product would go live on our site, down to a single step where products can go live on our site in less than a few days and suppliers can have full visibility into the process.

Additional investments are underway to reduce the amount of time it takes for a supplier to add products to our site by up to 50%. We also plan to add more personalized business intelligence reporting to our extranet to help our top suppliers optimize their sales. We have customer trends data on our extranet for suppliers to utilize today, and we are adding personalized analysis to help suppliers understand what their data means for their business. For example, suppliers will be able to view analysis on what styles or colors are underserved to assist in their design process and inventory planning.

I know there has been a lot of buzz in the furniture industry recently about 3-D modeling and augmented reality application. It is an area we have been working on since 2015 and where we believe we are industry-leading, so I wanted to provide a brief update on our progress. Today we have 3-D models for over 25,000 different SKUs, and this number is increasing rapidly every day. It is a small number compared to the over 8 million products available on our sites, but it is already a far larger 3-D model library than other retailers have by virtue of their more limited selection.

Today, these 3-D models are incredibly valuable for us as an inexpensive way to scale the lifestyle photography on our site at substantially less cost than traditional photography. We are also excited about the augmented reality application that will utilize these 3-D models and allow customers to see Wayfair products in their homes through mobile phone applications or 3-D headsets. Beta versions of our augmented reality and virtual reality apps are already available to the public via the Oculus and Google Play stores, but the real benefit will come in the next 6 to 18 months as more smartphones incorporate 3-D sensing technology.

More recently, we have been able to leverage our 3-D models as an upper funnel marketing tool. In March, we released a thousand of our 3-D models to SketchUp, a design modeling platform for interior designers. Roughly 60% of Wayfair interior designers use SketchUp and now they can use real Wayfair products in their models for clients, rather than generic stand-in products. We have also worked with real estate developers, visually staging model homes, and videogame developers who can link 3-D products back to Wayfair. In the future, we also expect to make our 3-D model library directly available to Wayfair interior design customers to assist in their shopping and design process.

We continue to be excited about the promise of 3-D and augmented reality applications in our space and look forward to increasing the size of our 3-D model library and rolling out additional customer-facing technology in this area in the coming months.

Before I turn the call over to Michael, I want to mention one management change. Our CTO, Jeremy Delinsky, was recently approached by a good friend with whom he worked very closely during his decade-plus at Athena Health to be their cofounder in a unique startup company in the healthcare space. As three-time founders ourselves, Niraj and I recognize the unique allure, excitement, and passion of founding a completely new company. So, sadly, we knew this was something he had to go do. We have a very deep intelligent leadership team at Wayfair and have asked John Mulliken to take the role of CTO. John has been at Wayfair for seven years and will, of course, work very closely with me, as Jeremy did. I expect this will be a seamless transition.

Now, I'll turn the call over to Michael.

Michael Fleisher:

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

In Q1, our Direct Retail business increased 32% year-over-year to $940 million and our Total net revenue increased 29% year-over-year to $961 million. Our Other business, which primarily includes revenue from our retail partners but also includes revenue from our small media business, decreased, as expected, to $20 million as we continue to ramp down our Retail partner business. To put these revenue numbers in context, I'll remind you of two factors that are worth noting.

The first item is that Q1 2016 was a difficult comp as it was the last in a series of 90%-plus Direct Retail growth comps we saw in late 2015 and early 2016. Secondly, I'll point out that on our last earnings call on February 23, we explained that Direct Retail growth revenue for the first quarter was comping at approximately 30% quarter-to-date and we were guiding 25% to 28% for the full first quarter. We finished the first quarter with Direct Retail revenue growth at 32% as a result of a particularly strong March in our U.S. Direct Retail business, momentum we have seen continue into April and May.

In the U.S. specifically, our Direct Retail business increased to $838 million, up 25% year-over-year. We believe the online market for our categories is growing roughly 15% year-over-year and we intend to continue taking share and growing at a rate that is well north of that market growth rate. There were some macro factors in our stronger-than-expected first quarter U.S. results for sure, including the catch-up of tax refund payments in late February and early March, but we've continued to see underlying strength in the U.S. business into Q2.

Our International business in Canada, the U.K., and Germany also exhibited strong Direct Retail growth in the first quarter, increasing 163% versus Q1 last year. As a reminder, we launched our Canadian site, Wayfair.ca, in the first quarter of 2016, so this is the first quarter where the International business is comping off a base that includes all three countries. That comp will become more meaningful for Canada throughout the year.

On a consolidated global basis, we finished the quarter with $8.9 million LTM active customers, up 46% year-over-year. We saw continued strong repeat purchase behavior with 60% of orders coming from repeat customers and LTM orders per active customer at 1.73, a new high watermark. Average order value for the quarter was $223, up 10% versus Q4 and down 6% versus Q1 last year. LTM revenue per active customer was $394, roughly flat to Q4 and up $2 versus Q1 last year.

I spoke on the last earnings call about our desire to strike the right balance between driving frequency of purchases, average order value, and LTM net revenue per active customer. At the end of the day, the metric we are currently most focused on is net revenue per active customer. It's worth noting that absent the mix impact of the International business, where revenue per active customer runs lower, LTM net revenue per active customer was up slightly versus Q4.

The remaining financials I'll share on a non-GAAP basis, excluding the impact of equity based compensation and related taxes, which totaled $15 million in Q1 2017. For a reconciliation of GAAP to non-GAAP reporting, please refer to our earnings release on our IR site.

Our gross profit for the quarter, which is net of all product costs, delivery, and fulfillment expenses, was $237 million or 24.7% of total net revenue.

In Q1 we continued to see higher than targeted gross margins. As we have always said, we expect to unlock margin over time based on our scale and our many initiatives, but we also intend to share in that margin with our customers. That sharing takes the form of being appropriately market priced and also better service for our customers, be that through faster delivery across our networks or higher levels of service, like weekend and evening deliveries. We also will continue to invest at the gross margin line in categories where we are not yet at full scale and in our International business. As such, we continue to target the business at a gross margin of about 23% and expect to be at those levels in Q2 and throughout 2017.

Advertising spend was $118 million for the quarter, or 12.3% of net revenue, compared to 13.1% in Q1 2016. As expected, ad spend as a percentage of revenue in Q1 is up sequentially versus Q4 2016 since we usually lean in more heavily on advertising early in the calendar year in order to take advantage of attractive market pricing for advertising. From a year-over-year perspective, this represents 80 basis points of ad spend leverage. Ad spend efficiencies are driven by our increasing mix of orders from repeat customers because we spend less on advertising to get an existing customer to buy again than to acquire a new customer. We continue to drive for only a modest level of ad spend leverage, driven by the growth of orders from repeat customers and continued efficiencies in the U.S., somewhat offset by the mix shift to international where ad spend runs higher as a percent of revenue because it does not yet have the benefit of significant repeat orders.

Our non-GAAP merchandising, marketing and sales expense and operations, technology and G&A expense are driven primarily by compensation costs. In Q1, these two-line items combined were $126 million dollars, up sequentially approximately $9 million dollars versus Q4 2016 due primarily to increased payroll tax, rent, and a $3 million increase in depreciation and amortization, most of which related to subleases signed this quarter in our Boston headquarters as part of our strategy to have enough space for our growth while managing our current period costs.

In the first quarter, we added 71 net new employees for a total of 5,708 employees as of March 31. We will continue to hire to keep up with the pace of growth and continue building out our teams that are going after our key initiatives. While we anticipate hiring for the remainder of 2017 will be at a rate above what it was the last few quarters, it will still be below the high watermark of hiring during the first half of 2016.

As we've described in the past, the build-out of our logistics networks, CastleGate and WDN—weigh on our P&L as we bear the burden of unutilized rent expense in op ex. For example, when we open a new CastleGate warehouse or WDN last mile delivery facility, we start recording rent expense on day one even though the space is empty that day. As we start flowing volume through the space and increasing utilization, the drag on our P&L lessens over time.

In Q1, the op ex burden of unutilized rent expense across our entire network ran approximately $5 million to $7 million, primarily impacting U.S. Adjusted EBITDA. As utilization of these existing facilities increases throughout 2017, their drag on the P&L will become less significant, though this trend will also be offset by the rollout of our additional CastleGate square footage in Southern California in Q2 and the opening of more WDN last mile delivery facilities before the end of 2017.

Adjusted EBITDA for the first quarter was negative $21 million, or negative 2.2% of net revenue. Adjusted EBITDA in Q1 for the U.S. business was positive $4 million, higher than the modest loss we anticipated due to our outperformance in revenue. Adjusted EBITDA in Q1 for the International business was negative $25 million, as expected, and consistent with the losses over the last several quarters as the international business runs at a lower gross margin, higher ad spend as percent of revenue, and higher relative op ex burden, as that business ramps up to scale. As a reminder, of the 5,708 employees we now have, approximately 700 of them, or 12%, are located in Europe.

Non-GAAP free cash flow for the quarter was negative $69 million based on net cash from operating activities of negative $46 million and capital expenditures of $23 million. Change in net working capital is typically a substantial use of cash for us in the first quarter. This is due to our normal seasonal pattern where we experience a large inflow of cash from sales in the holiday period that we then pay out to suppliers in the first quarter. CapEx spending was 2.4% of net revenue this quarter, below our forecasted level of 4% to 5%, due to the timing of our logistics facilities coming online and timing of our continued technology investments related to scale. For the full-year 2017, we still expect CapEx to run at approximately 3% of net revenue, though we expect some lumpiness quarter-to-quarter and a higher level for Q2.

As of March 31, 2017, we had approximately $310 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 Q2 2017. We forecast Direct Retail revenue of $1.015 billion to $1.035 billion, a growth rate of approximately 34% to 37% year-over-year. As I've done in the past to provide transparency, our Direct Retail gross revenue quarter-to-date is growing above 40% year-over-year.

As I mentioned earlier, we saw strength in the U.S. business in late February into March. Part of this is certainly tied to macro factors, and other retailers who have reported have mentioned the same. But we've also seen that U.S. strength continue in Q2 quarter-to-date, which you can see in the global gross revenue growth rate of north of 40%. We believe we are seeing the benefits of our focus on delivering for our customer and the many investments we're making across the business to deliver for her, a number of which Niraj and Steve have discussed today.

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 the customer needs to show up every day. There remains a massive shift from offline brick-and-mortar stores to online in our industry. We continue to expect to outstrip the underlying growth of the online market for home and to continue taking a substantial share of the market as it moves online. Our Q2 guidance reflects that, and the reality that giving guidance at the scale of our rate of growth and during an inflection of the growth is difficult at best. Over the last few quarters I've noted that the prior-year Direct Retail comps were especially high, at 90%-plus. For Q2 2017, the Direct Retail comp from last year is lower at 72%, but still high on an absolute basis. Our revenue guidance and quarter-to-date performance imply a strong growth rate and dollar growth for our scale, as well as continued online share taking.

We forecast other revenue to be between $15 million to $20 million, for total net revenue of $1.030 billion to $1.055 billion for the second quarter.

For consolidated Adjusted EBITDA, we forecast margins of negative 2.0% to negative 2.3% for Q2 2017. As we continue to invest in the International business, we expect it to continue running at Adjusted EBITDA losses consistent with the last few quarters. We expect Adjusted EBITDA for Q2 in the U.S. business to run at a similar level of profitability as it did in Q1, at or slightly above breakeven on an Adjusted EBITDA basis.

For modeling purposes for Q2 2017, please assume equity-based compensation and related tax expense of approximately $21 million dollars, average weighted shares outstanding of 86.7 million, and depreciation and amortization of $21 million to $22 million.

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

Niraj Shah:

Thanks Michael. Before we wrap up, I want to reiterate how excited we are about where the business is and where it's heading. There has been a lot of hard work to continue realizing our ambitious goals: building out our house brands; growing new categories; scaling our logistics networks to enable more two-day and next-day delivery; a differentiated large parcel delivery experience; and, lastly, scaling an International business in Canada and Europe. All this work is focused on delivering for our customer, who has continued to respond to what we are building for her. This shows in our growing base of repeat customers. That is the highest praise our customers can give us: to come back to Wayfair and purchase again.

A customer who comes back is the proof that our focus, ambitious goals, and hard work are delivering something unique for her. We're honored when that happens, and it drives us to find ever more ways to help her bring to life the aspirations she has for her home, and to make it fun and easy to do so. All 5,708 of us at Wayfair are driven by delivering that and are excited to see it show up in our results.

With that, I'll now ask the Operator to open the line so we can answer a few of your questions.

Operator:

If you would like to ask a question, please press star, followed by the number one on your telephone keypad. Again, that is star, one on your telephone keypad. Please limit yourself to one question.

Your first question comes from the line of Peter Keith with Piper Jaffray. Your line is now open.

Peter Keith:

Hi. Thanks. Good morning, everyone, and great quarter. I was hoping you could talk a little bit about the advertising strategy. You did see abnormally good leverage in Q1 and it's coming on the heels of discussion of maybe cranking up the U.S. advertising this year. Should we expect a bigger step up as we go forward or do you feel happy about the allocation of that spend and the customer acquisition cost?

Niraj Shah:

Hi, Peter. It's Niraj. Thanks for your question. I guess the way to think about it, one of the things we mentioned in terms of the way we manage advertising is the primary things we focus on in advertising is really, number one, the payback period, so making sure that we spend money to get new customers, we know the timeframe in which we're getting paid back, and we keep that to under a year, and you can kind of see that in that consecutive calculation that we provide. The second thing is we care a lot about what effectively the IRR over time is of that spend, but we don't view that as something we can calculate because so many of our efforts are focused on growing that IRR, so that cohort current that we how you is effectively showing the value of that.

So, in terms of when you think year-over-year leverage, there's so many things that affect that, there's the mix shift of domestic versus International, there's the mix shift within the different businesses within domestic situations. So, the way I would think about it is Q1 always has a higher ad spend relative to other quarters because we try to take advantage of the early-in-the-year buying, which tends to be highly, highly efficient. So, when you think about what we were able to take advantage of last year versus where we're taking advantage this year, you end up seeing a lot of leverage. I wouldn't guide you to kind of expect a ton of leverage, but I wouldn't guide you to expect that it needs to go the other way. We think ad spend as a percentage of revenue, the levels we've been at are levels that allow us to build all our brands in all the geographies, even with the negative mix shift effects that are in there, but I wouldn't look for lots of leverage because of those negative mix shift effects.

Peter Keith:

Okay. Thank you very much.

Niraj Shah:

Thanks, Peter.

Operator:

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

Seth Basham:

Thanks a lot, and good morning.

Michael Fleisher:

Hey, Seth.

Seth Basham:

My first question is just on the acceleration and growth rate that you guys hit in the Direct Retail U.S. business recently. Other than the macro comparisons, is there anything that you can point to, one or two factors that are most definitely driving that upside?

Niraj Shah:

Sure, Seth. It's Niraj. What I'd say—so I guess the biggest thing I would go back to—we really did try to touch on this in the script—is that we added a very significant number of people in 2016, basically against all the initiatives that we've kind of continually described on these calls for the last year-and-a-half, two years. But, when you add a lot of new people, it takes a while for them to ramp up and then a while for them to work on the things they're working on, and then those things roll out in the market and then they start to grow. So, long story short, I think a lot of what you see today is the hard work of the last year-and-a-half, two years paying off.

If you look at sort of—if you break apart repeat customers from new customers, you're seeing very good trends in both. You add that up, you're seeing the overall trend. So, in the U.S. business, it's very hard to point to just one or two things because of the combinational effective. We have a faster delivery through cascade, the higher quality large parcel delivery through WDN, the improved experience in merchandising because of the House Brands or because of the category efforts, like Seasonal Décor and Decorative Accent. All these things add up, so I wouldn't point to any one thing. I would say that we are pretty bullish that the investments we've been making are working and we think that there's still a lot of those gains ahead of us.

Seth Basham:

Got it. That's helpful. Thank you. Then, secondly, given your performance on EBITDA margins in the quarter, as you look at the progress through the year as comparison ease and you annualize some of these investments, would you expect to see positive Adjusted EBITDA by year-end?

Niraj Shah:

Michael really likes to guide the next six weeks or so, so I'm going let him give you the longer-term guidance. What I'll just give you for general feeling is what we try to explain a number of times is just we care a lot about the unit economics in our business and the way have been managing the business, depending on which line of business, but you have a variable contribution margin in that 19%, 20% range, and so we spend a lot of money to get a customer, but then that repeat revenue stream has a very high flow-through on it and you can see that repeats continue to grow faster than new for quite some time.

So, despite the investments, what will happen is that flow-through sort of exceeds the investments and that you start seeing it flow through in terms of diminishing losses and then eventually see a flow-through in terms of becoming profitable, and you see a flow-through to more and more higher level of profitability despite a good amount of continued investments, not increased amounts but good amount.

I'd tell you, the big thing we're focused on is we absolutely plan to self-fund the business and free cash flow positive has been a near-term goal and we feel very good about where we sit there. We grew the business by having it fund itself and that's certainly a big area of focus. But, Michael, if you have a specific comment?

Michael Fleisher:

No. I would echo the same thing, which is our near-term goal hasn't changed, which is to get the business to free cash flow breakeven or positive going forward and be self-funding and remain self-funding. I think we stated that as clearly as we possibly can. We're not going to put a date certain on it. We're not going to put a quarter certain on it. At the same time, continued strength in the U.S. business, obviously, what we're building here at this point is a business where at some point the U.S. profitability will outstrip the investments we're making in the International business, so continued strength which we're obviously seeing in the U.S. business only aids that process.

Seth Basham:

Very good. Thank you and good luck.

Niraj Shah:

Thanks, Seth.

Operator:

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

John Blackledge:

Great. Thanks. Just a couple of questions. Niraj, with the top line growth in the U.S. accelerating in 2Q, could you just talk about that in the context of the competitive environment and what you're seeing out there? Just second question for Michael would be: any reason the revenue growth in 2Q would slow down kind of in the back half of the quarter? Thanks.

Niraj Shah:

Sure, John. So, the first part, from a competitive standpoint, what I would say is we absolutely watch all the competition out there, but our general view has been and kind of remains that the market is pretty wide open. When you take a customer lens, what does the customer want, and then you look at what's been provided for her. There's a pretty big gap and we feel like we've always been closer to what she wants than most of the competitors we watch. Then, frankly, those investments we talk about are not investments in terms of us trying to create anything. They're really investments in terms of us focusing on getting closer and closer to what we've identified as what she wants.

So, from a competitive standpoint, I tend to think that our advantages are growing and that from a competitive standpoint we're becoming stronger relative to our competitors, but there's no specific thing we've noted where someone's gotten weaker and that's helped us, it's more we feel like we've gotten closer to the customer and that's helpful us.

Michael Fleisher:

Hey, John. It's Michael. So, there's nothing that I would specifically point to that would say here's the reason the back half of the quarter would be lighter than the first half of the quarter. I take a good bit of ribbing here for saying every quarter that we're a business that the customer has to show up every day, but the truth is the customer has to show up every day. So, macro trends are impossible to call. We've seen the impact of macro trends certainly over the last year or so, not just for us but everybody in retail, so I think we continue to try and be thoughtful in our guidance with the recognition that we're trying to peg the number six weeks into the quarter.

John Blackledge:

Thank you.

Operator:

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

Matthew Fassler:

Thanks a lot. Good morning. My first question relates to gross margin, which beat your guidance and the year-ago number quite nicely, and which you guided for Q2 well below the Q1 trend. Can you go into a little more detail about what drove that gross margin upside and whether there's anything in particular other than that long-term algorithm that will lead to margins to come down sequentially?

Niraj Shah:

Hey, Matt. It's Niraj. Let me just start with a question and then Michael can tack on any thoughts. So, gross margin, forecasting gross margin in our business, I think, is a little bit more complicated than in many in the sense that what you have in there, right. You've got the product margin, which you have a lot of—we have newer categories we're focusing on developing, so you've got mix shift there; we've got the International versus U.S. and every country is at a different stage on its maturity curve there, so there's mix shift there; then you've got the shipping costs, and we're in the middle of rolling out a bunch of logistics networks, so there's changes there that affect gross margin. So, what happens is a little bit of mix shift, a little bit of timing shift kind of moves it around from maybe where you thought exactly it would be. I would describe the amount of movement we've seen, even though it may feel significant on the outside, as kind of in the range that I think, for better or worse, you kind of feel comfortable that that kind of movement is going to happen with the amount of change we're introducing and the number of concurrent things we're focusing on and working on that would shift it either up or down even though each individual effort has very good unit economics.

So, it's not so much—you mentioned the pricing algorithm. I wouldn't say it's that we're focusing on lowering price. I would say it's more the mix shift of the actual component parts of the orders.

Michael Fleisher:

Yes. I think that's right. I think one of the things we said for the last two-plus years, right, is that we're going to continue to unlock margin through how we scale and the investments we're making, particularly in the logistics networks. At the same time, we've always said we intend to sort of share in that margin, that unlocked margin with the customer. We think that actually creates a really powerful fly-wheel effect in our business, both by sharing in terms of being appropriately market priced but also sharing with the customer in terms of really great service, right, whether that's weekend deliveries or evening deliveries or having something that was supposed to deliver in two days delivered next-day. So, at the same time you may unlock something in one quarter and it may take you another quarter or two before you can really start that sharing, and so I just think that there's a little bit of a balancing act there.

But at the same time, I'm trying to make sure that everyone understands what we're targeting is a 23% gross margin. We think that we'll be able to sort of strike the right balance to do that and we've been obviously overachieving that the last couple of quarters.

Matthew Fassler:

Then my second questions—so you continue to talk about the new categories that you're rolling out and I'm curious to the extent that you can discern it, what—the degree to which those new categories and the incremental assortments you have year-on-year are contributing to the revenue, particularly as revenue accelerates. Also, if I could, whether you find those categories attracting new customers to the enterprise or whether they are enhancing your traction with existing customers.

Niraj Shah:

Sure, Matt. So, a few thoughts, kind of the newer things, so in the U.S., these categories we're working at building out—Decorative Accents, Seasonal Décor, Housewares, the Home Improvement ones. They're not—they're growing nicely, but they're not contributing that much because they're still very small. Same with International, I mean, International is growing at $60 million-ish year-over-year. We think it'll keep growing like that, but that, again, is only a small piece of the total.

So, I think the way to think about it is just we're really happy with the progress, but the real contribution from those will be in the future where if they get larger and they'll still, we think, grow at quite a good rate. But, today, I would say they're more impacting—they're not really about new customer acquisition. What they're doing is they're letting us, for the current customers we get through the methods we use, offer them a richer and better experience, meaning that a higher percent of the categories they may shop us for are stronger in terms of the merchandising, the selection, and the offering. The ability for us to use our personalization technology and put something in front of them that's interesting to them, increases as these categories get built out and fleshed out. Then in the future, these could be substantially large categories. But, today, yet, they're not.

Matthew Fassler:

In terms of the customer, they appeal to, oh sorry. Go ahead, Michael.

Michael Fleisher:

No. Finish your question because I was going to cycle back to gross margin.

Matthew Fassler:

Sure. In terms of the customer that their appealing to, is this attracting a new customer to Wayfair or do you find that this is getting traction with your existing customer base?

Niraj Shah:

It's traction with the existing customer base.

Matthew Fassler:

Got it.

Michael Fleisher:

Yes. Matt, just to cycle back on gross margin, I do want to also just remind everybody that the International business trends at a lower gross margin, right, so as it increases in the mix, it weighs on gross margin, right, and as we continue to sort of make the investments in these categories that we're expanding in, we often aren't at the same level of scale that we are in other more traditional categories for us and, therefore, those have a weight on gross margin as well. So, those would be some other factors when you start to think about why it can be at a lower gross margin over the next couple of quarters.

Matthew Fassler:

Thank you so much.

Operator:

Your next question is from the line of Chris Horvers with J.P. Morgan. Your line is now open.

Christopher Horvers:

Thanks. Good morning. Wanted to follow up on the advertising question. As you get beyond 2Q you have rolled out the supply chain efforts in the United States, you talked about last year, holding back a bit on advertising because you were funding the expenses related to supply chain and wanted to stay self-funding. So, given the momentum in the business and the sun setting of the supply chain efforts, why wouldn't you step on the advertising to push on new customer acquisition?

Niraj Shah:

Yes. Sure, Chris. So, this is Niraj. So, our ad strategy has always been to max out the spend within a certain amount of payback periods and to do that across every channel. So, we've developed really strong relationships with Google and Facebook and Pinterest and all these folks, really worked on new ad units with them and know where everything is headed and we have direct mail capability and television, advertising capability for our mass brand for Wayfair. Cheryl Samberg was in our office last week and in the Facebook earnings call they mentioned an ad unit that we were working on with them.

So, we're not looking to be shy at all on ad costs, don't get me wrong there, we're going to be quite aggressive. That said, we think we're going to be able to continue to acquire customers and max out that payback period, while as a percentage of revenue the ad spend won't necessarily de-lever, which is what I was trying articulate. We don't necessarily think we'll get a lot of leverage either, but we think that absolute dollars can grow nicely and as a percentage of revenue, that that's a fair amount of money we will show, we think, really great performance on that. We don't necessarily think there'll be a lot of opportunity to de-lever, meaning to spend that kind of increasing dollars, we don't necessarily think we can keep the payback targets that we have in mind for every channel and every ad unit in line, so we don't chase that because we don't want to move that payback period out.

So, I just don't want you to be confused around how we think about it. We're not looking to be shy at all. We're looking to be quite aggressive. It's just that the ad costs—we don't envision needing to de-lever to do that.

Christopher Horvers:

Understood. So, maybe thinking about it another way, so it was always your intent to spend a certain amount of dollars and now you have this new momentum in the business or re-emergent moment in the business, and thus that's really driving how you're describing what the rate looks like?

Niraj Shah:

I mean, we don't usually target in dollars. So, we target kind of an economic return on the ad spend and then that can be any amount of dollars. Then we have a period of time where we're funding the logistics build-up, the International business, the advertising, and we said, from a free cash standpoint we just didn't love the amount of free cash that we were spending, so we said, hey, it'd be better to be a little prudent for a little while and manage that, and the place we chose to slow that, because International and logistics were both good long, cycle investments, was the ad costs for a little period of time because ad costs you lose money in the near-term period when you max that out, right, but you get paid back in less than a year. But that was, like, a transitory period.

I mean, in general, we basically view the ad cost as having an infinite amount of budget within fairly tight payback constraints.

Christopher Horvers:

Understood. Then just in terms of the acceleration, was there any quality characteristics or demand textures that you could share with us, existing versus new certain categories? Any geographic comment would be really helpful.

Niraj Shah:

Well, the one thing I'd say Michael did comment on this in the earnings script before we got into Q&A, but International continued to perform well and I mentioned it's like $60-odd million year-over-year it's been growing at, but we've seen a lot of nice momentum in the U.S. and so the one thing I would point to is that the U.S. is doing quite well. I think the reason I'm commenting on that is a quarter ago, I think there was a lot of concern that the U.S. business was slowing and what does that mean and where does it slow down to, and we tried to be articulate around, look, it's going to—we're doing so many things concurrently. It's going to be, maybe not a smooth exact light path, but think we expect to grow significantly above market on an ongoing basis. We still believe that and I think what I'm trying to comment on today is just that that's happening. Within that, though, there's—we're seeing pretty good performance across the board. There's no concentration in a particular category or one business line or what have you.

Christopher Horvers:

Thanks very much.

Michael Fleisher:

Thanks, Chris.

Operator:

Your next question comes from the line of Oliver Wintermantel with Evercore ISI. Your line is now open.

Oliver Wintermantel:

Morning, guys. I had a question regarding—you gave repeat customers, new customers, and all of that for the global business. Can you maybe break that out into the U.S. versus International? Then also maybe comment on the customer acquisition costs and how that's trending in the U.S. versus International? Thank you.

Michael Fleisher:

Yes. Thanks, Ollie. I mean, we're not, for now, going to split out the KPIs on a U.S. or International basis. I think the color commentary remains the same as it has in the past, right, which is we have a smaller—we have a much bigger base of repeating customers obviously in the U.S. than International and, therefore, most of the KPI metrics from an International basis look worse that the average we're showing you. I noted on the call that the revenue per active customer would've actually shown a little bit of growth if you looked at just the U.S. sequentially, so you can sort of see that whether it's revenue per active customer, gross margin we're generating, the repeat rates, etc., they're all lower internationally, which is typical and what we would've expected if you looked at what our U.S. business looked like five years ago.

Then from a customer acquisition cost perspective, there aren't sort of vast differences. We are still—we've turned on the ad spend in Canada and the U.K. Those markets are sort of ramping and scaling quite nicely now. We're starting to get—you can see the efficiencies we want, but we're not yet at a sort of scale basis where you have (audio interference) the repeat driving sort of the really great yields on the cap yet.

Oliver Wintermantel:

Okay. Great. Then just a clarification; the CastleGate and WDN, when you build your distribution facilities or transportation in Europe, are you using the same CastleGate and WDN, or is that a second stage where we can expect some more costs down the line or are you building that right now?

Niraj Shah:

Yes. So, they're both, like, kind of functions of scale and volumes. So, today, for CastleGate we've got operations in the United States. We also have a CastleGate warehouse in the United Kingdom. We'll continue to build out warehouses in Canada and Germany over time. WDN, the asset base large parcel network, basically is a function of volume that we'll continue to build out. So, it's not—think of that as—it's incremental as we go, so there's no, like, okay, well, now we need to build out International, so it's big year-round. We're kind of doing it as we go.

Oliver Wintermantel:

Got it. Thanks very much.

Michael Fleisher:

Thanks, Ollie.

Operator:

Your final question comes from the line of Michael Graham with Canaccord Genuity. Your line is now open.

Michael Graham:

Hi. Thanks a lot, and congrats. I just wanted to ask two. One on your House Brands, or I guess your Private Label, you had given a metric in the past about what portion of Wayfair sales that was. Just wondering if you want to update that, and can you talk about whether those suppliers tend to be exclusive with you or not. Then I just wanted to ask on CastleGate versus WDN in the U.S. Can you just comment on which one of those do you think will be sort of more fully complete earlier versus having a longer tail that might continue to scale in the long-term with volume? Thanks.

Niraj Shah:

Sure, Mike. So, to answer it—so, first on House Brands, they're actually—there was a comment on that in the script and so I think you might've just missed it, but we gave an update and we said that it was now up to 45% of the Wayfair.com business was the revenue coming from our House Brands, and that was up from the update two quarters ago, fairly significantly, which was up very significantly from the first update. So, that's continued to grow.

In terms of exclusives nature of it, the way we work is, like, rather than doing Private Label where we design the product, it's a very narrow range, we then source it from manufacturers in Asia or whatever and we try to inventor your balance sheet, what we do instead is we work with hundreds of our suppliers who are key partners and we basically take the newer introductions in particular and we put those into these brands. We do the work of curating them and the work of the visual imagery and the merchandising of it, and through that process, we think we add a lot of value to it. We also help the customer with navigation. We do a fair amount of work that way.

So, there's definitely—I wouldn't say you can think of the whole program one way or the other, but there's a lot of product that we're very thoughtful about where we don't mind it being distributed and where we wouldn't want it being distributed, and our core partners work with us on that, and that's kind of the way to think about how we think about exclusivity versus maybe a traditional kind of idea of a thousand items just for us.

In terms of CastleGate and WDN, I mean, they both had very significant volume benefits and they'll both continue to scale the volume, though they do it slightly differently. So, CastleGate, we kind of mention that we built up the first instance. With the warehousing now, what happens is suppliers have been testing and will ramp into it, so more and more items will become available as we get more and more utilization in these warehouses, we'll open additional ones, some in the same locations and some in new locations, to get us more and more coverage going from two-day to one-day on the small parcel side, and on the large parcel side, this is where the WDN fits in. What we have built out is a network that basically allows us to put virtually all our product through our own middle mile. We said by the end of the year we've planned for that to be 90%, but we mentioned 15 to 20 last mile delivery terminals covering about 60% of the population.

Well, over time, as we continue to grow the business, we'll be able to do more and more markets that we can roll that into, so it'll go from 15 to 20 markets at 60% and then, I don't know the math, but maybe it goes to 40 markets and that gets you to 80%, but there's a certain amount of volume you need for each individual operation to have enough scale. So, that's kind of the way you get benefits there.

But the core, so the initial warehouse network and then for WDN, the cross-dock facilities and the pull points, those are built out and that's where you see the rents—you need to go from not having facilities to having them with terminal managers and the like, being a big step up and that's what we've done recently and it'll—there's still a fair amount of unutilized rent that's in the cost, but that gets utilized over time.

Oliver Wintermantel:

Okay. Thanks a lot, Niraj.

Niraj Shah:

So, I think that was the last question, so with that, just, everyone, thanks for joining and we look forward to updating you again the next quarter.

Operator:

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