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Wayfair, Inc. (W)

Q4 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Kim, and I will be your conference operator today. At this time, I would like to welcome everyone to the Wayfair Q4 2018 Earnings Release and Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

Joseph Wilson, Head of Investor Relations, you may begin your conference.

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

Good morning and thank you for joining us. Today, we will review our fourth quarter 2018 results.

I would like to remind you that we will make forward-looking statements during this call, regarding future events and financial performance including guidance for the first quarter of 2019. We cannot guarantee that any forward-looking statements will be accurate, although we believe that we have been reasonable in our expectations and assumptions. Our SEC filings including our 10-K for 2018, which we expect to file in the near future, identify certain factors that could cause the company's actual results to differ materially from those projected in any forward-looking statements made today. Except as required by law, we undertake no obligation to publicly update or revise these statements whether as a result of any new information, future events or otherwise.

Also, please note that during this call, we will discuss certain non-GAAP financial measures as we review the company's performance. These non-GAAP financial measures should not be considered replacements for and should be read together with GAAP results. Please refer to the Investor Relations section of our website to obtain a copy of our earnings release, which contains descriptions of our non-GAAP financial measures and reconciliations of non-GAAP measures to the nearest comparable GAAP measures. This call is being recorded and a webcast will be available for replay on our IR website.

With me are Niraj Shah, co-Founder, Chief Executive Officer and co-Chairman; Steve Conine, co-Founder and co-Chairman and Julia Donnelly, Head of Corporate Finance. Before I turn the call over to Niraj, I want to let everyone know that Michael will not be with us for earnings today. He and his wife are at the hospital about to give birth to their daughter. We wish him all the best on their new arrival. Julia will be providing the financial update and answering questions with Niraj and Steve.

Now let me turn the call over to Niraj.

Niraj S. Shah

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

Thanks, Joe, and thank you all for joining us this morning. I am pleased to be sharing our fourth quarter and full year 2018 results with you today. Steve and I are delighted with the achievements of Wayfair in 2018 and the position that these accomplishments put our business in for the future, both in the U.S. and internationally.

In this year's shareholder letter, which you can find on our IR site this morning, Steve and I talk in more depth about the ways in which our business is bringing customers and suppliers together on our platform in an increasingly powerful way. Building a platform that will win at scale with customers and suppliers requires a long-term approach to investment and we could not be more proud of the steps our team of over 12,000 people continue to take in building the best possible destination to shop for the home online.

For the full year 2018, we generated $6.8 billion of total net revenue for a year-over-year growth rate of 44%. We added $2.1 billion in net revenue this year compared to $1.3 billion in 2017 and $1.1 billion in 2016. In the fourth quarter of 2018 specifically, we added $577 million of Direct Retail net revenue year-over-year representing the largest dollar growth in a single quarter in our company's history.

This outsized growth at scale is driven by the strength of our customer offering with a number of active customers at the end of 2018 exceeding 15 million and dollar revenue growth in our U.S. business accounting for approximately 35% of the estimated dollar growth in our category online last year.

This morning, I'll provide brief updates across a few key areas of our business, namely; holiday, our increasing penetration of the lighting category and logistics before I hand the call over to Steve. Before I turn to these topics, I want to talk briefly about our international business.

In Q4, international Direct Retail net revenue in Canada, the UK and Germany combined was $287 million. This represents year-over-year growth of 50% with our European business growing well in excess of that albeit off a lower base of revenue than in Canada or the U.S. today. Later in the call Steve will talk more about our European business, specifically Germany where we're seeing exciting progress with our suppliers, customer KPIs and brand awareness.

On our last earnings call I spoke about Canada which represents about 60% of our international net revenue and where we have brand awareness close to U.S. levels, and a marginally greater share of the Canadian total addressable market or TAM than we have in the U.S..

Today, we face a short-term structural cost disadvantage in Canada because the majority of our products sold to Canadian shoppers are being shipped across the border from the United States. Our business in Canada has grown at such a pace that in many ways has outpaced the development of our customer offering there relative to the U.S., particularly in logistics.

The opening of our first CastleGate facility in Mississauga, Ontario last year enables us to significantly reduce the added duty and logistics costs by making it possible for suppliers to land product directly in Canada from Asia. As CastleGate penetration in Canada increases, customers should benefit from lower prices and improved delivery speeds which we believe will enable us to reaccelerate the pace at which we are growing and winning market share.

While there have been some external macro headwinds over the last few quarters in Canada such as movement in the U.S. versus Canadian dollar exchange rate, and weaker consumer spending in Canada, such factors are transitory and do not influence the decade-long view we are taking in Canada. Overall, the growth we have seen in Canada since 2016 has been tremendous and underlines that our offering is working very well with customers there.

We see substantial growth ahead even off this larger base of revenue. With an estimated home TAM in Canada and Europe of more than $300 billion, and a proven playbook here in the U.S., we're very excited with the opportunity ahead of us internationally as we continue to scale this $1 billion annual run rate international business.

Now, let me turn to holiday. We had a very successful holiday season in Q4 which continues to be a great time of year for us to attract new customers to the Wayfair offering as well as engage with repeat shoppers. The Cyber 5 period continues to resonate strongly with customers with Direct Retail gross sales growing 58% compared with the same period last year. Within that, Black Friday, traditionally more of a brick-and-mortar sale event for shoppers, grew more quickly than the other days of the period as it did in 2017.

Our deep level of planning with suppliers was integral to our ability to offer customers great selection and value over the period. As a result of this collaboration, we ran discounts on over twice as many products compared to last year while seeing overall gross margin for the Q4 period run over 100 basis point higher than the same period last year. Over Q4, as a whole, we ran 20 promotional holiday campaigns, leveraging a wider set of new and differentiated offers to maintain high engagement throughout the period, including gift card incentives, free shipping, and flash deals.

Flash deals were particularly successful with customers in our Way Day event in April of last year with the strongest flash deal categories during Cyber 5 including TV stands, curtains, and bathroom vanities.

We're delighted that customers are rewarding us with their dollars at a time of year when competition is often at its most intense.

On previous earnings calls, we've spoken about the head count we're adding across the business to enable us to increase penetration of categories within our total addressable market, where we're historically under-indexed and to further strengthen the services we offer our shoppers to enhance our overall offering. We've been able to build a real scale over the last few years in a handful of categories that today are growing nicely and each generate annual gross revenue in the $500 million to $1 billion range. With a large TAM and relatively low online penetration, we see huge opportunity ahead in these categories. In other categories where we have invested more recently, it's exciting to see them now become multi-hundred-million-dollar revenue categories for us and continue to grow at a high rate.

Today, I want to talk in more detail about the steps our team is taking in the lighting category. Lighting is a broad and complex category with over 30 different sub categories on our site, spanning indoor and outdoor items, hardwired and plugged, fashion and technical and many others.

Like other home categories, consumer shopping for lighting often cannot articulate exactly what they are looking for. This is particularly the case as they may not know what lighting style they like, say mid-century modern or coastal, or how to articulate the fixture design that they are looking for in a chandelier such as globe, sputnick, or wagon wheel. The category is also largely unbranded further limiting the ability to search the category.

The Wayfair platform we have built to solve those issues is very well-suited to the lighting category. In lighting, our overall offering has strengthened as a result of the continual improvements we're making across our site, as well as the important category-specific steps we have taken. We've doubled the size of our cross-functional lighting team over the last two years to over 40 people and they've heavily focused on building out selection to more than 180,000 SKUs and making the category as inspiring and easy to shop as possible. These 40-plus people, focused on lighting in areas such as merchandising, category management and supplier operations, are in addition to the more than 12,000 people working across the business to bring customers the best possible experience.

In addition to our vast selection, our teams have focused on enhancing the visual merchandising and overall shopping experience of the lighting category, which we believe sets us apart from the competition. We've leveraged our collection of over 80 house brands to help customers easily find products in the style and price-points they are looking for.

In Q4, 2018, house brands grew to approximately 74% of Wayfair.com net revenue, up from 57% for 2017 as a whole. We've also simplified the shopping experience by creating on-site aids like visual filters so customers can easily navigate to the fixture design they are looking for even if they don't know its name.

Our lighting product pages are built to both inspire and educate our customers. On the product detail page, customers are presented with all the key product information in an easy and digestible way. For example, we have visual symbols calling out the most important details customers want to know so that they can buy the product with confidence. These symbols indicate whether the fixture is dimmable, hardwired or requires placement in a dry area amongst other possible specifications and helps the customer easily understand the more technical aspects that are often unclear.

As a category that can be highly emotive, we've partnered with our suppliers to build-out a rich library of 3D imagery that can inspire customers as they look for the perfect dining room light, kitchen island pendant or wall sconce. These 3D models also enable customers to use our technology to visualize their purchase in their own space, such as in our 3D viewing room and Room Planner functionality. This is a key part of a supplier success on our platform and we couldn't have achieved this without the collaborative approach we've built over the years.

CastleGate plays an important part in the growth we're seeing across the business and that is very much the case in lighting. Today, lighting is the number one product category flowing through our CastleGate warehouses in terms of unit volume, with suppliers seeing the considerable benefit a program can bring to improving delivery speeds offered to shoppers and in reducing damage over time. The success we are seeing in lighting is result of a large number of steps we're taking across our business to leverage our core platform while tailoring the offering to the specific needs of shoppers in the category.

Today, lighting is one of the categories in the $500 million to $1 billion gross revenue run rate range I mentioned earlier and in 2018, it grew by more than 50% on the prior-year. The substantial scale it has reached today and the continued high-growth we're experiencing in the category highlight the potential that we see, not just for some of our larger categories like lighting, but also for dozens of product categories that are currently earlier in their progress, including the few we've mentioned on previous earnings calls such as bathroom vanities, and outdoor décor, structures and spots.

Now, I would like to give you a brief update on the development of our logistics infrastructure before turning the call over to Steve. At the end of 2018, we had approximately 12 million square feet of space in North America and Europe across our CastleGate and WDN facilities. Looking forward, we expect to add approximately 5 million square feet of space across our network in 2019. We expect to add approximately 3 million square feet of this space in our CastleGate facilities in the United States, approximately 1 million square feet to CastleGate internationally and approximately 1 million square feet to our WDN last-mile delivery facilities as part of our logistics build-out.

The dollar value of U.S. small parcel revenue being shipped from the CastleGate network continues to grow at pace, almost doubling in Q4 2018, compared to Q4 2017, accounting for approximately 26% of U.S. small parcel revenue in the quarter, up from approximately 19% in Q4 of 2017, and we will be targeting further growth this year.

In Q4, we continued to build-out our large parcel home delivery infrastructure. Today, we're operating 35 of our own last-mile delivery facilities in North America, up from 27 at the end of Q3 2018 with the addition of Phoenix, Milwaukee, Columbus, Austin, San Antonio, Las Vegas, Kansas City and Cincinnati. These give us coverage of approximately 74% of our U.S. large parcel home deliveries.

We're excited to see that the improved service level we can offer as a result of these investments is resonating with customers, with Net Promoter Scores in regions where we have taken over control of last-mile home deliveries now being approximately 25% higher on average than those served by third-party operators. At the end of 2018, over 90% of our U.S. large parcel orders flowed through the Wayfair-controlled middle mile network of consolidation centers, cross docks and line haul.

Now, I want to touch on our inbound supply chain where we are continuing to take greater control. At the end of 2018, over 80% of the inbound volume to our U.S. warehouses was container-direct, enabling us to reduce cost and complexity for our suppliers.

Further upstream, this time last year, our first ocean container pilot shipment left China and following the success of the pilot, we now anticipate that approximately 40% of the container volume into our U.S. CastleGate facilities will come from suppliers that have chosen to purchase inbound supply chain services with us including ocean freight and drayage. We see this as a powerful development of our relationship with suppliers as they look to us to take greater control of inbound transportation from Asia, removing the need for them to liaise with numerous third-parties typically involved in that process.

This increased level of supply chain control has enabled us to launch an internally-developed ocean freight visibility platform on our supplier extranet, giving the suppliers the ability to track in real-time the progress of container shipments throughout the inbound journey. We're giving suppliers greater control, reducing the time they spend on supply chain administration and ultimately improving product availability for customers.

In 2019, we're looking forward to continued uptake of inbound supply chain services as a result of the foundations we have built over the course of the last 12 months. With that, I'll now turn the call over to Steve.

Steven K. Conine

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

Thanks, Niraj. In prior earning calls we've spoken about the success we're seeing with customers internationally as we put our proven U.S. playbook to work in Canada, UK and Germany. Last quarter, we talked about the pace at which our Canadian business has developed where we see continued gains ahead. Today, I want to talk about the exciting progress we're making in our least mature international region, namely Germany.

I was in Germany twice this quarter to meet with suppliers at major trade shows in the country and I was struck by the enthusiasm and commitment we are generating with them. Some of those suppliers were with us in 2015 when we had approximately 60,000 products on our site to today, when we have approximately 600,000 products on our site. We are excited to be working with them to get to over 1 million products this year, as we further accelerate the flywheel of our business there.

Supplier engagement is central to bringing customers the best possible offering. What I took away from those supplier interactions was a clear sense that partnering with us was much easier and more powerful than they had appreciated when I saw them 12 months earlier. Suppliers have transitioned from wanting to believe that our platform can transform their access to online shoppers, to now being true believers and are really leaning in make it work.

Much like we saw in the U.S. business several years ago, suppliers are investing in their e-commerce teams and working very closely with us to learn how to be successful on our platform. They frequently underline how surprised they are by the deep level of support and collaboration they are seeing from our teams to help them scale their business on Wayfair.

Much like the historical development of the U.S. business, we are working closely with suppliers, many of whom are relatively new to e-commerce, to help reduce the friction they face in their early efforts to access customers shopping for the home online. This can range from developing 3D product imagery to drive product conversion, to getting products to customers as quickly and smoothly as possible by joining our CastleGate program, following its launch in Germany last year.

As large equity holders in the business, Niraj and I have always taken a long-term approach to how we invest for growth which we believe will serve us well in Germany as it has in the U.S. We have a culture that is highly quantitative with data being a core determinant of how we best serve the customer's needs today and out into the future.

Today, we are thrilled to be investing behind the strength we are seeing in the KPIs of our German customers and in the momentum we're building with suppliers in the region as they join our platform. We are investing aggressively in Germany for several reasons. The first is that we have seen our U.S. and Canadian businesses grow successfully over time and have a depth of customer performance metrics that we have been able to track during those periods. We are now seeing those metrics take shape in Germany which allows us to invest aggressively to build our business there.

Our business today in Germany has considerable parallels with the U.S. business shortly after we launched the Wayfair brand in the U.S. in September of 2011. Brand awareness in Germany in the summer of last year when we first started testing TV advertising was at a similar level to the U.S. when we took that step. We saw great results from our early TV ad campaigns in the U.S. and are very pleased to see our initial spend in Germany contributing to aided brand awareness in Q1 being more than twice the 2018 level.

Earlier this quarter, we also launched a partnership with one of Germany's best known entertainers, Barbara Schoeneberger, who will feature in our first major TV campaign there as we continue to raise customer awareness of the Wayfair offering.

At a customer level in Germany in recent quarters, we are also seeing new shoppers repeat with us at similar rates in their first 30 days of purchase as they did in the U.S. at similar levels of brand awareness. This is a key indicator of marketing spend effectiveness and future lifetime value. With these and many other proof points, we are able to invest with a high level of conviction, often taking steps earlier and with greater certainty than we did as we scaled the U.S. business. For example, in opening CastleGate in Germany sooner than we did in the U.S. given the confidence we now have in the concept.

The second factor that influences our appetite to invest in Germany is the scale of the TAM in our category which, at approximately $75 billion, is over three times the scale of the Canadian market and 50% larger than the UK. We believe we will be the leader in our category online in Germany as we continue to win with customers and take more market share and we are building our business with that long-term scale very much in mind.

Finally, we believe that businesses often underestimate the investment required to expand successfully internationally. This can stem from a belief that expansion can be managed principally from the home market with a small presence on the ground internationally. Our firm belief is that by having an initial focus on the two most attractive markets in Europe and building the best possible teams in those markets, we have the greatest likelihood of achieving substantial scale and profitability over the longer-term.

We've built great foundations in Europe with approximately 1,700 people-based there who contribute globally as well. For example, today, Berlin is Wayfair's second global product engineering center. We had an initial focus on European transportation and storefront nationalization. Following those successes, we expanded the team to have a global remit including payments technology and supplier-facing tools. We're delighted with the results of the collaboration we're seeing between our teams in Berlin and Boston as we keep innovating for customers and suppliers in 2019 and beyond.

With that, I'll now turn the call over to Julia to discuss the financials in more detail.

Julia Brau Donnelly

Head of Corporate Finance, Wayfair, Inc.

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

In Q4, our Direct Retail business increased 41% year-over-year to $1.996 billion representing year-over-year dollar growth of $577 million which, as Niraj highlighted earlier, is the largest increase in our history. Our total net revenue increased 40% year-over-year to $2.014 billion. Our KPIs, which we report on a consolidated global basis, demonstrated continued strength in Q4. As Niraj mentioned earlier, total active customers surpassed 15 million, up 38% year-over-year with the addition of approximately 1.3 million net new customers in Q4, a new high watermark for net new customers.

Often when we describe the continued investments and leaning in we are doing on ad spend, we mention that we expect ad spend in one quarter to lead to customer additions in future quarters. Last quarter, we described leaning in on ad spend as we were seeing good opportunities within our strict payback thresholds. Those decisions and similar decisions throughout last year lead to this type of extraordinary growth in net new customers.

Moreover, purchase frequency, as measured by LTM orders per active customer, grew for the eighth consecutive quarter reaching a new high of 1.85 in Q4. Average order value was $227 which was lower than Q3 consistent with the seasonal trend of lower ticket holiday items being purchased in Q4. Orders from repeat customers in Q4 grew 51% year-over-year, approximately twice the rate of orders from new customers, continuing the strength we saw throughout 2018.

In the appendix of our investor presentation, you will see that over the course of 2018, our Wayfair.com customer cohorts continued to strengthen and we're very pleased to see that the investments we're making in our business are resonating so strongly with new and returning shoppers.

Turning to our U.S. business, our Direct Retail net revenue increased to $1.709 billion in Q4, up 39% year-over-year. This represents year-over-year dollar growth in the quarter of $481 million in U.S. Direct Retail net revenue.

As Niraj highlighted earlier, Direct Retail net revenue from our international businesses in Canada, the UK and Germany collectively increased to $287 million, up 50% versus Q4 2017. We're extremely pleased with the gains we have made internationally over the course of 2018 and how we are positioned to keep winning with customers internationally over time.

I will share the remaining financials on a non-GAAP basis, excluding the impact of equity-based compensation and related taxes which totaled $41 million in Q4 2018. For a reconciliation of GAAP to non-GAAP reporting, please refer to our earnings release on our IR site.

Gross profit for the quarter which is net of all product costs, delivery and fulfillment expenses was $486 million or 24.1% of net revenue. Typically, we enter Q4 prepared for an intense promotional environment, this year we were thrilled to see the analytical and collaborative approach we take with our supplier partners result in a product offering that not only resonated strongly with customers during the peak period but also did so at prices that resulted in improved margins for the quarter. For Q1, we expect gross margin to be toward the upper end of our guidance range of 23% to 24%.

In Q4, advertising spend was $232 million, or 11.5% of net revenue as expected. As we mentioned last quarter, we are continuing to see great opportunities to invest advertising dollars and generate ROIs within the approximately one year contribution margin payback that is central to our approach.

In Q1, we expect higher sequential ad costs as a percentage of net revenue, as we keep leaning in on efficient ad spend opportunities in the U.S. and internationally and as a result, we expect to see approximately 100 basis points of deleverage year-over-year. The international business, particularly the UK and Germany, continues to invest a significantly higher proportion of net revenue in advertising than in the U.S. as we build brand awareness and the scale of our repeat customer base increases internationally.

In the U.S., our Wayfair.com business is showing great strength against the main KPIs we track. We were able to reach new customers efficiently and within our payback limitations due to the deepening strength of our brand and the many investments we have under way to make the discovery, purchase and delivery experience better for our customers every day.

Also, we often find the first quarter is a particularly good quarter for efficient ad buying since many traditional advertisers who buy through agencies are not in market as they await approvals of their annual budgets. We will continue to invest behind the high ROI advertising opportunities we see as we are very pleased with the new customer KPIs we're seeing across our business and are confident in the incremental value these customers will add over their lifetimes, which is evident in the continued growing strength of our customer cohorts.

Our non-GAAP selling, operations, technology and G&A expenses, which I will refer to as OpEx, are driven primarily by compensation costs and in Q4, totaled $268 million excluding the approximately $2 million impact of a one-time gain related to the termination of our Ogden, Utah warehouse lease at more favorable terms than previously anticipated.

In 2018, we had substantial OpEx hiring, bringing great talent into our business to support our three main investment areas of building out our international capabilities, developing our proprietary logistics network and increasing penetration of categories in our total addressable market where we have historically under-indexed.

We added 1,215 net new employees in the fourth quarter for a total of 12, 124 employees as of December 31, 2018. Of these 1,215 net new employees, approximately 850 were in variable cost areas of our business, namely in our logistics operation and in customer service. Please remember that we are heading head count in these areas not only due to the growing scale of our business but also as we are effectively in-sourcing work that was done by third-party logistic providers in the past.

The other approximately 360 net new hires in Q4 were in OpEx areas, such as marketing, merchandising, operations and technology, a sizable step down, as anticipated, from the 850 people hired in these areas in Q3. This resulted in almost 2,400 net new OpEx hires for 2018.

As we stated last quarter, we anticipate running our OpEx hiring at lower levels this year than we did last year as we focus our teams on executing the many initiatives we have ongoing. As a result, we expect OpEx hiring over the next few quarters to remain at similar levels as in Q4, except in the third quarter of 2019 when we expect it will step up some due to the success of our campus recruiting programs that bring great new talent into Wayfair in a concentrated period over the summer.

As a result of the ongoing build-out of our CastleGate and WDN facilities, we expect unutilized rent to continue to weigh on our P&L in 2019. As a reminder, generally, our logistics rent costs run through COGS, but as we open new facilities, we are required to allocate the unutilized portion of the rent in those facilities to OpEx. As Niraj mentioned earlier, we have been growing our footprint and expect to further grow our logistics base in 2019 and this will add to unutilized rent as will the implementation of changes to lease accounting standards which impact our build-to-suite leases.

As a result, we expect an increased burden from unutilized rent going forward. Specifically, in Q1 2019, unutilized rent will be in the range of approximately $10 million to $15 million. Approximately $2 million to $3 million of this amount is the impact of the changed lease accounting standard.

Turning to profitability, adjusted EBITDA for the fourth quarter was negative $54 million, or negative 2.7% of net revenue. Adjusted EBITDA in Q4 for the U.S. business was positive $8 million and adjusted EBITDA for our international business was negative $62 million. Non-GAAP free cash flow for the quarter was negative $23 million based on net cash from operating activities of $43 million and capital expenditures of $66 million.

As usual in Q1, we expect to see a material out flow of cash in the quarter primarily as a result of the seasonal working capital movement that follows the holiday period coupled with our timing of CapEx investments in facilities and technology which will be higher than average in Q1.

CapEx spending was 3.3% of net revenue for both Q4 and 2018 as a whole. We expect CapEx to run at approximately 5% of net revenue in Q1. We had $970 million of cash, cash equivalents and short and long-term investments as of December 31, 2018 following the issuance of a convertible loan note in November. This funding further strengthened our balance sheet with attractive capital and should give us flexibility in both positive and negative macroeconomic environments and enable us to remain opportunistic. Further details on the convertible notes can be found in our SEC filings on our IR site.

Now for Q1 2019 guidance, we remain very bullish on our business both near-term and long-term. We forecast Direct Retail net revenue of $1.86 billion to $1.90 billion, a growth rate of approximately 34% to 37% year-over-year and representing year-over-year Direct Retail dollar growth of approximately $500 million.

To give transparency on current trending as we've done previously, our Direct Retail gross revenue quarter-to-date has grown above 40% year-over-year. As a consumer facing business, macro factors can impact our results and the overall confidence of the consumer and timing of tax refunds are therefore some factors we are mindful of in Q1. We forecast other revenue to be between $10 million and $15 million for total net revenue of approximately $1.87 billion to $1.915 billion for the first quarter.

Within our total Direct Retail net revenue guidance range of 34% to 37% year-over-year growth, we expect U.S. Direct Retail growth in the range of 33% to 36% and international Direct Retail growth in the range of 35% to 40%. As our international business has grown, the impact of currency swings has started to have a greater impact on our reported results. This is particularly noticeable with a focus on our international growth rates.

For example, for the full year 2018, our international net revenue as-reported grew 70% year-over-year, yet on a constant currency basis it grew 69%. This past quarter in Q4, international growth as-reported was 50%, yet on a constant currency basis it grew 56%. We craft our guidance for revenue growth on an as-reported basis but it's worth noting that on a constant currency basis, our guidance would be approximately 45% to 50% for international growth and gross sales quarter-to-date for international are up more than 50% on a constant currency basis.

As Niraj mentioned earlier, Canada, which has rapidly become a scale business with great market penetration, now represents approximately 60% of our international net revenue. Some of the headwinds we are feeling there have Canada growing at a slower rate which is impacting the total international growth. The UK and Germany continue to grow at a rate far in excess of our overall growth rate as they gain momentum and are taking share and penetrating their markets.

We are continuing to make the investments in our business in the U.S. and internationally that are resonating with customers and have been central to our success to-date. As we've mentioned before, we've always invested in a way that best serves our customers over the long-term and we do not link our spending in a particular quarter to revenue in that quarter. As has been the case in prior years, we expect OpEx as a percentage of revenue to de-lever sequentially in the first quarter of the year as payroll taxes reset for the New Year and we bear the full cost of the more substantial hiring we've done over the last few quarters.

As a reminder, many of these new members of our team are working on initiatives that are not yet revenue-producing and are investments to deliver for our customers over the longer-term. We do continue to expect to see modest year-over-year leverage in this line toward the latter part of this year as we annualize the substantial head count growth of last year.

Combining this with the ad spend opportunities, we continued to see in the U.S., we anticipate that the U.S. adjusted EBITDA will be negative 1.5% to negative 2% for the quarter. The U.S. business has been adjusted EBITDA profitable for seven of the last nine quarters and we expect that incremental flow-through from our growth will continue to improve U.S. adjusted EBITDA over time, though, as always, we won't time our investments to make that happen in any particular quarter.

Q1 historically is our lowest EBITDA quarter of the year as we typically experience a small sequential decrease in revenue while having normal seasonal increases in ad spend and employee costs. For consolidated adjusted EBITDA, we forecast margins of negative 5.2% to negative 5.5% for Q1 2019. These losses are primarily driven by our international business with adjusted EBITDA in the range of negative $70 million to negative $75 million internationally.

As Niraj and Steve mentioned earlier in the call, we're extremely pleased with the gains our business is making internationally and we're increasing our investment accordingly as we position ourselves for further market penetration, much like we did successfully here in the U.S. For modeling purposes, for Q1 2019, please assume equity-based compensation and related tax expense of $52 million to $54 million, average weighted shares outstanding of 91.1 million and depreciation and amortization of $40 million to $42 million.

Now I'll turn the call over to Niraj before we take your questions.

Niraj S. Shah

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

Thanks, Julia. I would like to reiterate how proud Steve and I are of what the business achieved in 2018 and the position that we have put ourselves in to take advantage of the opportunity we see ahead of us, both in the U.S. and internationally. Dollars in the home category are continuing to move online and we believe we can keep taking in outsized share by delivering the best customer experience with vast selection, inspiring visual merchandising, fast and convenient delivery and world-class customer service.

We're seeing customers increasingly reward us with their dollars, and we are delighted to be investing behind this strength. With that, I will now turn the call over to the operator so that we can take some of your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from Peter Keith from Piper Jaffray. Your line is open.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Hey. Good morning, everyone. Congratulations again on the solid results here. I did want to dig in on one topic though that wasn't brought up in the prepared remarks and that is on the sponsored advertising because we're seeing that ramp on your site quite nicely just in the last couple of months since it was launched. What I was curious about is where that will show up on the income statement, how it might be reported whether it's revenue or as an offset to overall advertising and do you think it had any impact overall on this most recent quarter? Thank you very much.

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

A

Thanks Peter. I'm going to let Julia explain where it shows up on the P&L, how it's accounted for, but one thing I want to just highlight. We're actually thrilled with how it's going but it's still very much early days. So the actual – the dollar volume of the impact is quite small, but we're very optimistic about where it will go and the reaction we've had from suppliers has been incredibly positive. So we think it's going to be fantastic but it is early, but Julia why don't you address the accounting.

Julia Brau Donnelly
Head of Corporate Finance, Wayfair, Inc.

A

So Peter, on sponsored SKUs, we're required to report that as a counter COGS line item so that's where it'll appear on the income statement.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay, great. And actually if I can sneak in one more for Niraj. You had mentioned around the Asia freight, I think it was the inbound would be about 40% of the CastleGate sail/revenue. Was that something that you plan on getting to this year or was that a target over time? And then correspondingly, where within operating metrics do you think that ramp will start to show improvement?

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

A

So I think if I could just explain what the 40% number is. So 80% of the volume in CastleGate facilities comes in container-direct from the origin which generally is Asia. The other 20% is coming into our CastleGate facilities from domestic supplier warehouses. That 80% obviously that's coming container-direct is much more efficient from a logistics cost standpoint. That's obviously very attractive to the supplier, their ability to pass-through a lower wholesale and obviously therefore have a lower retail.

If you look at the CastleGate, that volume, 40% of the container volume, so half of that 80%, is from suppliers who are using us for some piece of that inbound supply chain, so drayage or ocean or both, and the reason they use us for that is it's a chance to save money, it's a chance to improve in-stock availability, it helps with the visibility, it speeds up the chain and so that's where we're at today. So basically half the volume that's coming in today, we already have suppliers using us for some form of inbound and so we were just citing that to just show that the inbound services which we've piloted a year-ago have now started to really take off.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay. Thank you very much. That's helpful. Thanks. Good luck.

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

A

Thank you.

Operator: Your next question comes from John Blackledge from Cowen and Company. Your line is open.

John Blackledge
Analyst, Cowen & Co. LLC

Q

Thanks. Two questions. On the gross margin, I think it was 24% in the quarter, your commentary suggested it would run at like 23%, so just any color on the upside there. And more generally as we head into 2019, just thoughts on gross margin and potential levers for upside.

And Niraj, thanks for the color on logistics and fulfillment. The question would be, given the long-term opportunity, how should we think about kind of where we are in the CastleGate and WDN build-out? What inning are we in for these respective fulfillment programs and for CastleGate, what is the difference in conversion for a CastleGate good versus a non-CastleGate product? Thank you.

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

A

Thanks, John. On your first question, so gross margin. So we've talked a lot over the years about how we think gross margin. We have a long-term model, which is basically unchanged since we went public in 2014, we show a gross margin number of 25% to 27%. And what we've described is that the path there is actually much more straightforward and simple than people might [ph] ascribe (44:27) because there's some levers built into the business automatically that play out over time and we cite three things that will drive it up and I'm going to mention a fourth.

So the three that we've mentioned a number of times, one is that just with more and more volume, basically suppliers are willing to operate on a lower margin in order to drive throughput and that's a source of gross margin benefit.

The second, we talked about is as the house brands that we've launched take share, that dense price competition is the way we add value that allows for gross margin expansion. The house brands, by the way, we just referenced have been growing dramatically, and so if you look at that as just under 70% for the year last year is higher than that on a run rate basis now. So you can see that that's actually worked over the last three years and that leads to the ability to take margin.

The third is that the transportation and logistics efficiencies, transportation and logistics costs amounts to about $0.20 of every revenue dollar if you take the piece we pay plus the pieces our supplier pays, so as we can address more and more of those and add efficiency, those basically are savings that can accrue.

And so all of those things are playing out and there's huge upside, most of which is ahead of us and we've said a number of times, each one of those three buckets can close the gap to the 25% to 27% if we wanted it to. The reason we show 25% to 27% is simply because we don't expect to keep all of it. We expect to pass some of it back to the customer and savings.

Now the fourth thing I just want to mention is there's a mix shift effect because international geographies, any new effort whether it's a new category or new geography, starts to lower gross margin and over time as it scales and we become a meaningful player looking at efficiencies and where we have better buying power, the margin rises.

And so that's the other thing that plays out over time because right now we have so many things that are either emerging categories – if you look in our investor presentation, at slide 26 where we talk about all of the new services all the new categories or places we're bolstering the teams, look, generally a newer category also would be associated with lower gross margin, international geographies similarly, so as those become more mature that will average up the margin, that's more a mix effect than anything else but that's the other thing.

So the way to think about the future is that gross margin will rise. Now, we're not focused on trying to drive that prematurely. That's going to be more a natural outcome of these things playing out but that is something that we continue to see and it's a really great outcome because we can offer the customer greater value while also having the gross margin rise through this natural outcome.

On your second question, so that was the margin question. The second question was about the logistics, CastleGate, WDN. So there what inning we're in, we would still be in the early innings but, as you know, we think about our whole business as in the early innings. The reason I'd say we're in the early innings on the logistics is that while we've built a number of these operations, a lot of the gains come as these things continue to get more and more mature.

So for example, on the inbound services, we talked about drayage and ocean. We're only finishing our first full year of offering those, and there's a lot of technology we know we can build that adds efficiency, as we add more and more warehouse locations and couple that with the Asian consolidation operations that we're only building now. There's a lot more cost efficiencies that couple with faster speed of delivery to the consumer that will come on line, so on and so forth.

On the WDN facilities, we mentioned a number of cities that we opened just this last quarter, Phoenix, Milwaukee, Columbus, Austin, San Antonio, Las Vegas, Kansas City and Cincinnati. We're opening these at the rate of one or one or two a month and we'll continue to do that this year. At some point, you get to small enough markets where it doesn't make sense to open them just yet because we need some more volume before it justifies their own operation but right now there's still a list of cities we're working on, a long list, that would add a lot of value. And when you look at like the NPS jump there, the 25% jump, that's a huge – 25% jump in NPS is very hard to unlock. So when you can get these kinds of gains, they're very large.

So the way to think about that logistics operation is we're in the early innings of getting the gains. So what's nice is we're far enough in that we know it works, we've been able to prove it, we've been able to measure customer satisfaction increases and measure how we can save money, but we're still in the early innings of reaping those gains and that's what's really exciting. And we're replicating this internationally. So we have the Canadian CastleGate warehouse that came online last year. That's a great example because when we talk about the Canadian business, scaling that operation is going to unlock huge growth in the Canadian business as you move to next-day delivery and you lower the sort of double duty, double transportation cost situation you have on all the volume that comes into the United States and then moves northbound over the border. So there's a lot of gains. UK and Germany, we're building large operations there as well.

John Blackledge
Analyst, Cowen & Co. LLC

Q

That's great. Thanks so much.

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

A

Thanks, John.

Operator: Your next question comes from Maria Ripps from Canaccord. Your line is open.

Maria Ripps
Analyst, Canaccord Genuity, Inc.

Q

Great. Thanks for taking my questions. It seems like you have been experimenting with physical store locations over the holidays and with the permanent location that just opened in Kentucky, can you maybe just talk about your strategy here and how this brick-and-mortar strategy complements your online strategy?

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

A

Sure. Thanks, Maria. So let me kind of mention a few things when you think about stores. First, let me just start with we think about stores in the way we think about marketing channels and so we've always talked a lot about our advertising spend and we've talked about how we measure that on a payback basis. So rather than using a budget or some prescribed percentage of revenue we're willing to allocate to marketing. Instead we measure it in what I think is really the only pragmatic quantitative way to measure which is the contribution margin that that effort generates needs to cover off that cost in a very finite period of time because that's the only way you know that you're actually spending wisely.

Well, we used to only do online advertising and then as we forayed into television and then direct mail, and direct mail, for example, now might be, I don't know, roughly say 10% of our total ad spend, TV might be on the order of 15%. We figured out how to measure each one of these so that we use the same kind of framework. Well, when we think about physical stores, we similarly would focus on having a way to measure the impact in a way that doesn't allow for double counting and to make sure that we're only going to scale a model if in fact it drives that same kind of quantitative payback.

Now, why do we have any interest in stores? Well, if you think about, for example, television, well, a 30-second television spot can tell a story in a way that an online text ad can't or an online display ad can't. Well, that's a value-added television. So there's certain things you can do, well, how you then do it in a way that makes sure you get the payback, there's creative ingenuity, targeting ingenuity, so on and so forth.

Same thing if you think about direct mail, what can you do with a catalog or a trifold or a postcard? There's different things that you can do, different impact you can have. If that catalog sits around on the coffee table for a few months, how can that have an impact?

Well, we think stores and in-person interaction considering the breadth of what we offer and the high-touch service experience we offer, we think there's certain things you can do in a store. So that's why we are investigating it.

Now, we're investigating stores three different ways. The permanent store you're referring to, I would say, is the least relevant of the three to what I just said which is simply that our returns run at 5%, so relatively modest amount, but the yield on that 5% has not historically been an area that we focused on optimizing.

Starting about a year-and-a-half ago, we had an effort to really how do we get the yield on our returns up and there's a lot of things you can start to do like rugs, you can reroll, re-bag rugs, so on and so forth. There's things you can re-box certain items. Well, there's a lot of items in what we sell that the best way to get the yield is to put it in some sort of outlet center, liquidation-type store but where we're getting a significant gain relative to just selling it to a liquidator.

So the store in Kentucky is the first of what would be a relatively small number of stores focused on more of the liquidation and sale of returns to significantly up the yield we get relative to what we could do in any other channel. And so that's a very narrow proposition very focused on that use case, but meaningful when you look at the P&L [ph] returns (52:48).

The other two efforts I would reference would be more of what I think you were alluding to which is more of a permanent store basis and so the one effort we talked about are the pop-up stores. So we had two pop-ups during holiday. That was our first foray. We learned a lot from that and we'll kind of iterate and if we can get to a model that has high quantitative payback, we would then look to see how would it make sense to scale it, is it a seasonal thing, is there a time of year, is it about certain locations, so on and so forth.

And then the third would be where I think you were thinking is about a permanent store that's meant for the primary goal of customer acquisition and increasing kind of the value of revenue per customer per year which would have that payback math and we would think of it like ad spend. We don't have any of those stores today, but we think about that and at the point at which we have something that makes sense, we'll talk about that as well. But we think about – the Wayfair proposition is a very broad proposition and so there's a lot of opportunities still ahead of us.

Maria Ripps
Analyst, Canaccord Genuity, Inc.

Q

That's very helpful. Thank you.

Operator: Your next question comes from Brian Nagel from Oppenheimer. Your line is open.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Hi. Good morning. Thank you for taking my questions. Nice quarter. So I have two questions that maybe I'll merge into one. First off, just with regard to the macro environment, and I know Julia you had mentioned some of the risks out there, but from a retail perspective, there's clearly been, over the last several weeks or so, choppiness brought on in part by the government shutdown. So the question I have, and we clearly can't see it in your reported results, but did you – was there an effect on Wayfair's business or were you able to sort of, say, act in certain ways to offset this?

Then the second question I have with respect to gross margin and a bit of a follow-up from a prior question, but Niraj, you talked about, in your prepared comments, the relationship or the way you're working with suppliers now to manage promotions. Should we think about this now as somewhat of a paradigm shift in terms of driving gross margin or is that just a normal course of business for Wayfair? Thank you.

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

A

Thanks, Brian. So first let me answer your second question first and then I'll go to the first question. On gross margin, and you're talking about managing promotions with suppliers, we've always done that. So there's nothing new there, and if anything, it's not only normal course of business, but we've just focused on how do we make it easier and better, like better planning, better planning tied to inventory availability, how do we plan a little further ahead, how do we give suppliers self-service tools.

Like, for example, one of the things we launched last year is a clearance area on our site, so suppliers can, just through the extranet, launch items into the clearance area by passing through a discount to help manage their overstocked inventory and that's more productive for them, for example, than the other ways they have to liquidate.

So we think about promotion as very multi-faceted. There's like planning for the major events, there's these types of things which could be day in/day out events and so – but that's a normal course of business and it's part of – I think, what's been different – we really partner with suppliers and that's a very unusual approach for a retailer and one of the things – actually, I just want to mention this and I'll come back to your questions.

On the IR website today, we posted obviously the [ph] regular bit of (56:05) press release, what you're accustomed to, the updated presentation, which I want to touch on in a second, but also our annual shareholder letter, and I would encourage everyone to just take a couple minutes to download that shareholder letter and read it, if you are interested, because we try to talk in some detail in that about how we think about the business.

And there's a notion, which is significant, and we've talked about it but I don't know if everyone fully understands it. So the more we talk about it, I think the easier it is to understand, which is we don't think of ourselves – even though our economic model is that of a retailer, we don't think of ourselves in the traditional method of a retailer where you sit in between the suppliers and manufacturers and the end customers. We actually think of our role as creating a platform that enables suppliers to actually reach the end customer and what we need to do is provide a platform and infrastructure that allows for a great customer experience.

So in some cases what that means is building tools for suppliers for them to be able to merchandise their offering, for them to be able to promote their offering and do things that – basically they know their products better than we do. How do we let them connect that directly to the customer and tell that story?

And then in some areas, building that kind of platform means we need to build things that our suppliers can't build on their own. So for example, our logistics capability that reduces damage and offers next-day delivery and two-day delivery and eventually same-day delivery, that's not something our suppliers can build. So we need to build that. Or the customer service that we offer with the thousands of people we have who are amazing people, that's not something our suppliers can offer consistently, so we offer that.

And so creating a platform and doing it in partnership with our suppliers is very unusual approach. We think that's unlocked a tremendous amount of growth. And so I think that letter does a good job summarizing, so I won't try to read you the whole letter right now, but take a look at that.

I want to just say one thing in the investor presentation that you might find interesting. We used to put a cohort slide in every quarter. We would update it at cohorts going back to 2011. We, last year, mentioned we're going to discontinue that because we're going to kind of keep focusing on more and more data that looks to the future.

Well, this year, at the end of this year, we said, hey, why don't we just put in an update of that because this is data that's really interesting. We're not going to update it every quarter, but we included that in there. So I think for those of you that followed that slide in the past, it's slide 36 in the presentation. I think you'll enjoy seeing that.

What we intend to do in the future is not necessarily keep updating the same materials. We're going to keep changing the materials to talk about things that are interesting and new and perhaps give you insight into areas of the businesses as they grow that you don't have the same insight into, like maybe in the future we'll talk about international or something like that and break that out more.

But to get back to the question, so gross margin, suppliers [indiscernible] (58:46), so that's normal matter of business, normal course of business and partnering with suppliers is something that we invest a lot of effort into. I've been to three European trade shows since January 1 as well as a couple of major U.S. ones. I know Steve's been to Europe a couple times, which he talked about on the call, he talked about Germany and there's a bunch more coming up. We have a big supplier event every June. So there's a lot we do to further that.

And then last, let me wrap with the macro choppiness. To be honest, I mean, does the macro atmosphere, would it affect us? I mean, you'd be crazy to say no, but the truth is not much. Not much. Julia mentioned growth quarter-to-date, it's over 40%. We're seeing incredible momentum and what's important to realize though is the reason I say not much on the macro choppiness is that when you grow at 40%, it becomes a little less relevant whether the total market is growing 0%, 2% or 4%.

The reason you can grow 40% is you're taking share and we're taking share because online is significantly taking share to offline and we're taking share because online tends to be very concentrated and we're providing the best experience and getting rewarded for that. If you do the dollar share taking math that we've talked about in the past, last year you would see, based on the estimates we have, we took 35% of the incremental growth dollars that moved online, we still think there's a lot of upside based on these newer categories, newer geographies so we're thrilled with where we sit, but thank you very much.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.
Q

Thank you.

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