VIAVID
communications simplified.

Wayfair Inc.

Second Quarter 2015 Earnings Release Conference Call

August 12, 2015

CORPORATE PARTICIPANTS

Kate Gulliver, *Head of Investor Relations*

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

Steve Conine, *Chief Technology Officer, Co-Chairman and Co-Founder*

Michael Fleisher, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Matt Nemer, *Wells Fargo*

Neely Tamminga, *Piper Jaffray*

Deb Schwartz, *Goldman Sachs*

Austin Moldow, *Canaccord Genuity*

John Blackledge, *Cowen and Company*

Oliver Wintermantel, *Evercore ISI*

Paul Bieber, *Bank of America Merrill Lynch*

Mark May, *Citi*

Aaron Kessler, *Raymond James*

PRESENTATION

Operator:

Good morning, ladies and gentlemen. My name is Chris and I will be your host operator on this call. At this time, I would like to welcome everyone to the Wayfair Q2 2015 Earnings Release 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, followed by the number one on your telephone keypad. To withdraw your question, press the pound key.

At this time I would like to introduce Kate Gulliver, Head of Investor Relations at Wayfair. Please go ahead.

Kate Gulliver:

Good morning and thank you for joining us. Today we will review our second quarter 2015 results. With me are Niraj Shah, Co-Founder, Chief Executive Officer and Co-Chairman; Steve Conine, Co-Founder and Co-Chairman, and Michael Fleisher, Chief Financial Officer. We will all be available for Q&A following today's prepared remarks.

I would like to remind you that we will make forward-looking statements during this call regarding future events and financial performance, including guidance for the third quarter of 2015. These statements are only predictions based on assumptions that are believed to be reasonable at the time they are made and are subject to significant risks and uncertainties. You should not rely on these forward-looking statements as representing our views in the future.

Except as required by law, we undertake no obligation to publicly update or revise these statements. Our actual results may differ materially and adversely from any forward-looking statements discussed on this call. For a discussion of factors that could affect our future performance, results and business, please refer to our Annual Report or Form 10-K, our quarterly report or Form 10-Q, which we expect to file in the near future, and other reports we have on file from time to time with the SEC.

Also, please note that during the course of this conference call, we may discuss certain non-GAAP financial measures as we review of the Company's performance. Please refer to the Investor Relations section of our website to obtain a copy of our earnings release, and the slide accompanying this call which contains descriptions of our non-GAAP financial measures and reconciliations of non-GAAP measures to the nearest comparable GAAP measures.

This call is being recorded and a webcast is available for replay on our IR website.

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

Niraj Shah:

Thanks, Kate, and thank you everyone for joining us this morning. We are pleased to share our second quarter results which show the ongoing strength of our business model.

The total business grew 66.4% year-over-year to $491.8 million in revenue for the quarter. Our direct retail business, which in Q2 was almost 90% of the total, grew 80.8% year-over-year for total revenue of $440.3 million for the quarter. As a reminder, our direct retail business primarily sales of the website and apps of our five brands: Wayfair.com, Joss & Main, AllModern, Birch Lane and DwellStudio.

The direct retail growth rate this quarter is the fastest growth we've seen since Q1 2014 and reflects both the ongoing strength in new customers and the increasing repeat behavior from our existing customers. We ended the quarter with 4 million active customers, an increase of 53.5% of Q2 2014 and a net increase of approximately 447,000 customers from the prior quarter. While new customer growth is strong, we are particularly excited about the repeat behavior we see from our current customers. The percentage of orders from repeat customers increased this quarter to 56.6%, up from 53.9% in the prior quarter, and annual orders per active customer increased to 1.67 from 1.64 in the prior quarter and 1.62 in the second quarter of 2014.

As we shared last quarter, we believe that the continued growth in both new customers and repeat behavior was partly a result of the strategic shift we made to our advertising strategy in early 2014 when we both increased our advertising spend and focused on attracting higher value customers who we believed had a higher propensity to repeat. Accordingly, we have seen the second quarter in a row of increasing revenue growth combined with year-over-year ad spend leverage. Ad spend as a percent of sales in Q2 was 12.5%, 190 basis points improvement from Q2 2014.

We also believe that the sustained revenue growth we are seeing is a reflection of a truly differentiated customer experience from on-site discovery and selection through to delivery. As I talk to our customers, one of the things they always comment on, in addition to our broad selection and our great prices, is our customer service team. Our customers really love being able to call up and get live customer service support to help them with their questions. About a year ago we opened our third US customer service center in Orem, Utah. We now have close to 800 customer service representatives in four centers globally: Galway, Ireland, servicing our European customers, Boston, and Orem and Ogden, Utah servicing North American customers.

We believe skilled and thoughtful customer service is a key part of the home goods buying experience. The home category has a higher average order size, often more complex delivery and in general is a more considered purchase, which can lead to customer service calls across multiple points of the order process. We were see pre- order calls from customers looking for further information on everything from the firmness of a soap thought to how their teak dining set will weather when left outdoors. Our talented employees are prepared to answer these questions with highly specialized training in key categories and they will work with the customer to help her find the perfect item and ultimately help her place the order. Post order placement, we receive calls on delivery timing, product set up, and if necessary, how to handle returns or damages. While we continually strive to make our on-site experience as complete as possible, we do believe that given the nature of the purchase there will always be some amount of customer support necessary and we are not only happy to provide it, but we focused on exceeding her expectations. As our organization grows we continue to expand the customer service team and are currently evaluating locations for our next customer service center in the United States.

Another way we work to differentiate the experience for our customers is through a unique and growing private label strategy. Over the past year we've launched several private label brands on Wayfair.com. This approach allows us to work with our existing supplier base to curate a specific look and feel with unique products and to scale this model without taking inventory. Launched earlier this year, Three Posts is an example of one of these brands. It offers a traditional American esthetic at a moderate price point. Three Posts offers over 500 different products across a range of categories, which we have sourced from a variety of suppliers. We create these product assortments by selecting items, building the collection, merchandising the items, which includes shooting our own photography. We are particularly excited about the engaging imagery the brand uses, allowing customers to really imagine how the product would look in their home. The Three Posts brand can only be found on Wayfair. Three Posts and brands like it enable us to provide the customer with a better shopping experience through unique products and curated styling. We're able to work with our suppliers to offer products that fit the style and price point our customers seek while we are also building a differentiated selection on Wayfair. Similar to how we operate all the various facets of our business, we are building these brands and selections without carrying inventory.

Now, before diving deeply into the numbers, I would like to hand the call over to Steve to touch on engineering and technology developments.

Steve Conine:

Thanks, Niraj, and good morning everyone. As many of you likely saw from our press release in May, Jeremy Delinsky recently joined our team as Chief Technology Officer. As our engineering team has grown, we now have over 350 engineers and data scientists. Niraj and I increasingly felt the need to bring someone in on the technology side with the experience to help us scale this critical part of our organization. We are very excited to have Jeremy join the team and help us in that endeavor.

Prior to working with us. he was at Athena Health for over 10 years, one of the most innovative companies in the healthcare software services space, where he was CTO over four years and most recently Chief Product Officer. In his role as CTO at Athena Health, Jeremy oversaw the development of the R&D team from 200 to over 1,000 employees. His leadership helped the team to expand and scale their efforts in software development, user experience and technology infrastructure. As CPO, he led the development and commercialization of Athena Health emerging products. At Wayfair, Jeremy will use this expertise in building teams, infrastructure and innovation to help us appropriately structure and scale the organization in this period of rapid growth.

Jeremy will report to me and I will work closely with him on these initiatives on a day-to-day basis, but I'm also excited to be able to have some more time to focus on larger, strategic issues for engineering and product development and the company more broadly. We are very excited to have Jeremy join the team and help us build the leading site for the home.

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

Niraj Shah:

Thanks, Steve. I'll echo Steve's enthusiasm about Jeremy. Our technology is really the backbone of our organization. We use it to power all facets of the business, including merchandising, marketing and operations. Ensuring the success of this team is critical for our end-to-end customer experience. We are very excited to have Jeremy on board.

We are also pleased with our second quarter performance, particularly the acceleration of the direct retail growth rate and the improvement in repeat behavior from our customers. The growth the business is experiencing as a result of the work we do on the front end to enhance the customer expense and the work we do on the back end to interface with suppliers and improve logistics. Combined, these efforts are helping to create the ultimate shopping destination for the home.

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

Michael Fleisher:

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

In Q2, our total net revenue grew 66.4% year-over-year to $491.8 million. As Niraj described, this growth was driven by the direct retail business which grew 80.8% over Q2 2014 to $440.3 million. Our Other business, which includes revenue from our small media business and from our retail partners declined 0.9% over Q2 2014 to $51.5 million. This decline is consistent with our strategy to focus increasingly on our direct retail business, now almost 90% of the total business, where we own the customer relationship.

Our gross profit for the quarter, which is net of all product costs, delivery and fulfillment expenses, was $120.8 million or 24.6% of net revenue. This is compared to 23.2% in the same quarter last year and 24.2% in Q1 2015.

The change in gross margin on a quarterly basis is a result of normal fluctuations due to the wide range of products we sell and the benefit of larger scale. As we shared with you before, we believe the appropriate gross margin threshold for the business in the near term is mid- 23 to low 24%. It is not our intention to remain at this quarter's gross margin level of 24.6%, so we are giving some of this margin back to the customer in the form of price, delivery and customer service.

The remaining financials I'll share on a non-GAAP basis, excluding the impact of equity based compensation and related taxes which totaled $7.1 million in the Q2 2015 and $974,000 Q2 2014. As a reminder, prior to the IPO, we only had equity based compensation expenses recognized in relation to tender offers. Post the IPO, we recognize equity based compensation each quarter in all line items that have headcounts. For reconciliation of GAAP to non-GAAP reporting, please refer to our earnings release on our Investor Relations website and the slide that accompanies this call.

Customer service and merchant fees were 3.7% of sales compared to 4% in the same period last year and consistent with Q1. In general, we view this cost as a variable expense that will stay fairly consistent overtime. As Niraj pointed out earlier, the small portion of this expense that represents our customer service team generates nice return in terms of customer satisfaction and repeat buying behavior.

Advertising spend was 12.5% of revenue in the quarter or $61.5 million. Year-over-year advertising spend as a percentage of sales improved 190 basis points from 14.4% of revenue in Q2 2014 and improved 120 basis points over Q1 2015.

As we described in the last two calls, we anticipate ongoing year-over-year leverage in ad spend as repeat buying continues to grow. We spend far less on advertising to get our existing customers to buy again than to acquire a new customer. Therefore, as orders from the existing customers become a larger portion of the base, we anticipate continued improvement in ad spend leverage.

This quarter, we did see higher than anticipated leverage due to our strong revenue performance. As we have described before, we carefully manage ad spend throughout the quarter and we only spend when we believe we get the right ROI and visibility on payback, and our view and target on these metrics has not changed. Therefore, with the revenue outperformance this quarter, we saw some incremental flow through resulting in increased leverage. I do want to make clear that we remain committed to aggressively spending to gain new customers and will lean-in any time we have opportunities to scale customer acquisition in a way that hits our ROI and payback goals.

As Niraj highlighted in his remarks, we saw particular strength in the repeat business this quarter with orders from repeat customers up to 56.6% of total orders. LTM net revenue per active customer grew 7.5% to $357 annually and LTM orders per active customers grew to 1.67 from 1.62 a year ago. While we do anticipate quarterly fluctuations in repeat measured, we are excited about the strength in our core customer base.

We also saw strength the new customer acquisitions this quarter. We added approximately 447,000 net new customers, more than we have ever added before. We believe our growing brand awareness and the investment we've made in brand advertising, both in TV and online, have helped to drive new customer acquisition.

Our Merchandising, Marketing and Sales spend on a non-GAAP basis was $20.6 million or 4.2% net revenue compared with $13.1 million or 4.4% of net revenue in Q2 last year. Non-GAAP Operations, Technology and G&A expense was $32.8 million for the quarter or 6.7% of sales compared to $23 million or 7.8% of sales in Q2 last year. These two line items are primarily headcount and the increase in spend, both on a year-over-year basis and on a quarterly basis, is due to ongoing investment in our teams. Our hiring efforts continued to scale in the second quarter where we added over 225 net new employees. Even with over 225 net new people starting, we saw greater leverage on operating expenses as the pace of hiring was not as fast as we'd like to keep up with the revenue growth. We continue to add to our recruiting team to help increase the speed of hiring in the upcoming quarters as we believe it's important to invest in our team now to meet the growing needs of our business.

Adjusted EBITDA for the quarter was negative $5 million or negative 1% of net revenue compared with negative $17.6 million or negative 6% of net revenue in the same quarter a year ago. The year-over-year improvement in EBITDA margin was driven by leverage in advertising spend and headcount, as I just described. Although we increased total advertising dollars spent and rapidly expanded the team in the second quarter, revenue growth outpaced our ability to invest and hire, contributing to more flow throughs than originally forecast.

Non-GAAP free cash flow for the quarter was positive $11 million. This positive free cash flow was driven by net cash from operations of $28.5 million, primarily as a result of the favorable working capital dynamics in our business. The positive cash flow from operations was offset by $17.5 million in capital expenditures for the quarter.

Non-GAAP diluted net loss per share was negative $0.15 on 83.6 million weighted average common shares outstanding. As of June 30, we had $366.7 million of cash, cash equivalents, and short- and long-term investments.

Our inventory level was just $21.3 million or 1.3% of LTM sales. It's worth noting that although the overall business has grown 66.4%, inventory has stayed fairly constant at just $19.8 million in the same period last year.

Overall, we are very excited with our second quarter results and the continued strong revenue growth from both our new and repeating customers.

I'd now like to offer guidance for Q3 2015. We forecast direct retail revenue of $445 million to $475 million, a growth rate of approximately 56-66% over the same quarter last year. Given the extraordinary growth that we've recently seen in the direct retail business, I want to give a little more context for this guidance then we typically do.

The 56-66% growth rate is faster than the guidance we gave on our last earnings call, but still below the nearly 81% growth in the direct retail business in Q2. In our business, growth is ultimately based on the customer showing up every day, so it's very difficult to forecast that the recent growth rate sustains, particularly as we enter a period with increasingly higher sales on a dollar basis in the prior year.

We are trying to manage the guidance process to be transparent and not give outsized beat as happened in the past quarter, but we also want to be prudent as we are only midway through the quarter. Recently in Q3, we have experienced a direct retail growth rate above our guidance of 56-66%, but at a rate that is lower than the Q2 direct retail growth rate of 80.8%.

We expect Other revenue to be between $45 million to $50 million for total net revenue of $490 million to $525 million. We forecast EBITDA margins of negative 2.5 to negative 3%. We will continue to invest in the business to create sustained growth in the long run and do not expect to see the level of flow-through that we saw on last quarter's revenue beat. As I previously described, we will invest this coming quarter in advertising as long as we can get an efficient, timely ROI, and hiring, where we continue to grow our team to both support our current scale and invest to staff all the initiatives that will drive our future growth.

For modeling purposes for Q3 2015, please assume equity based compensation expense of $11 million, average weighted shares outstanding of 83.9 million, and depreciation and amortization of approximately $8.3 million.

Before turning the call back over to Niraj, I want to touch briefly on our announcement in July about the sale of our Australian business. As a reminder, our international business as a whole is less than 6% of total revenue, the vast majority of which is our European business. We see significant opportunity in the US and Europe and as we scale and we want to focus our efforts on growth in these large markets. The divestiture of the Australian business helps us to strategically align our resources with these priorities. As the sale occurred in July, the proceeds from the sale, which were immaterial, will be accounted for in our third quarter financials.

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

Niraj Shah:

Thanks, Michael. We are excited about our second quarter results and the continued momentum in our brand. We believe these results are a direct reflection of the strategic shift we made in advertising in 2014 and the ongoing investments we are making every day to make Wayfair the leading destination for all things home. Strong customer loyalty is driving higher growth and improving leverage, which will ultimately help us deliver long-term value to our shareholders.

We think the home space represents a fantastic market opportunity and we look forward to sharing more good news with you throughout the year.

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

Operator:

Thank you. At this time I would just like to remind everyone in order to ask a question please press star and then one on your telephone keypad. The first question is from Matt Nemer with Wells Fargo Securities. Your line is open.

Matt Nemer:

Good morning everyone and congratulations on a great quarter.

Niraj Shah:

Thanks, Matt.

Matt Nemer:

My first question is on gross margin. Just curious if you can talk to the factors that led that to jump a little outside your targeted band. Is it a function of mix, private label or something else, and then secondly, as you reinvest some of that upside, will we see that in prices or shipping speed or some other part of the customer experience?

Niraj Shah:

Hey Matt, it's Niraj. You basically answered the question I think the gross margin increase, it does come —private label certainly helps and we are trying to aggressively grow private label. Mix obviously affects it. The other thing I'll point to is we've talk about transportation cost efficiencies in the past and a lot of the things that will benefit us with transportation costs and leverage come out of scale and obviously we are growing which helps.

In terms of where we will reinvest it, there is obviously multiple places to reinvest it, different aspects of the customer service expense; you talked about fast shipping, you talked about lower prices and effectively we collect a lot of information and then we reinvest it sort of in multiple areas where we think we get the most benefit.

Matt Nemer:

Okay, great. Then secondly, I'm just wondering if you are seeing any pressures on the business given the higher than expected growth. You talked about trying to push a little bit harder on hiring. Any movement in customer service metrics given the revenue upside in terms of maybe speed to pick up a call or time to ship? Anything like that that might have been impacted by the outsized revenue growth?

Niraj Shah:

We have always been a very customer service oriented organization. For first few years the only way we hired people in the company is you actually start in customer service; Steve and I answered calls for probably the first four years of the business. We still do a lot of customer work, so we definitely are very keenly focused on those metrics. Needless to say, as we grow faster we obviously need to scale our customer service organization faster, but we are kind of well attuned to that. I think one of the things you heard on the call, we're going to be opening another customer service center in the not-too-distant future. So we try to stay ahead of it with our planning and that is sort of the key way we think about it. We actually brought in a new Head of Customer Service just a few months ago, Liz, who is off to a great start.

So long story short, I think there will always be bumps in the road and we do our best to stay ahead of them and the growth we are seeing now, the benefit of it I guess is we have always kind of been attuned to growth and trying to stay ahead of it, so that's a little bit of the life we lead.

Matt Nemer:

Just to finish up, I realize Wayfair is far and away the biggest brand, but any commentary on how the different brands may be performing?

Niraj Shah:

You know, we don't really give breakouts of the brands, but I guess the way to think about it is exactly what we've said in the past, which is Wayfair is by far and away our biggest brand and so at the end of the day, when you look at our overall direct results, there is no way that Wayfair could be far away from that in either direction.

Matt Nemer:

Got it. Great. Congrats again. Thank you.

Male Speaker:

Thanks, Matt.

Operator:

The next question is from Neely Tamminga from Piper Jaffray. Your line is open.

Neely Tamminga:

Good morning and congratulations on a great quarter, you guys. Just want to ask a little bit more on the repeat behavior. It sounds like that's really very much a call out, Niraj. If you kind of dig deeper into the data, we are just wondering if you have some qualitative or common distinctives across the board with some of these repeat customers, their buying behavior. For instance, do they kind of crescendo or escalate in their frequency? What does the average ticket look like? How are they behaving versus maybe your daters versus the people who are marrying you, in terms of your brand, and just are they assimilating into other categories? Any sort of qualitative commentary you could offer there would be really helpful. Thanks.

Niraj Shah:

You know so there is no acute reason the repeat overall is growing. It's a combination of two key things. One is that a higher percentage of people who buy for the first time come back and buy again, coupled with the fact that the people who buy again buy more than they did previously, right? So both of those axes are advancing and we view that as a good sign.

Our business is not one that is really about whales so it's not a super small population driving a very large percentage of revenue. So say you have bigger customers in smaller customers, but it's really much more broad-based, which is why we look at things like the ongoing growth in the brand strength of Wayfair. We think Wayfair is on its way to becoming a national brand. So we look at awareness and favorability and a whole series of things to measure that. We look at the sources of our traffic and are we getting any increasing amount? People are coming; they're either directly typing in Wayfair or they're directly engaging with us, whether it's through our app or through our e-mail or what have you. There's a whole lot of things we look at. All of those I think are effectively leading indicators for this continued growth in repeat and we believe we are on a kind of continued good trajectory there.

Neely Tamminga:

Great, thanks. One follow-up question, just more on the final mile sort of delivery program. Could you just remind us where you are in your process in terms of do you have physically Wayfair trucks kind of in that final mile delivery, and are you in all the key states you want to be in, or where are you again on that process? Just as an update.

Niraj Shah:

Sure. So the way I would describe that, there's definitely—is not a finite journey that we started and we'll end. It's something we have kind of continued to make it better over time, over many years, but the phase we are in now is we are increasingly moving to dedicated delivery operations where whether it's us operating it or a partner operating it, it's dedicated to Wayfair orders. By dedicating to Wayfair orders, they can follow our procedures and our service levels for every order on the truck every day which then allows the drivers to specialize; it allows us to use our technology around scheduling and things like this. So that's the phase we are in now and I would say we are not that far into that phase. There are some markets that operating in that manner but we are still in the early days of fully growing that out.

Neely Tamminga:

That's helpful, Niraj. Good luck, you guys, here in Q3.

Male Speaker:

Thanks, Neely.

Operator:

The next question is from Deb Schwartz with Goldman Sachs. Your line is open.

Deb Schwartz:

Great. Thanks and congrats on the quarter. Two questions, if I may. First on the average order value, it was flattish year-over-year, but up sequentially quarter-over-quarter Can you help us understand if there is seasonality in that metric and how we should think about it going forward? Secondly, just to follow up on purchase frequency, any changes you've been making in terms of personalization or recommendations or even retention advertising spending that have been additional drivers of that metric in the quarter?

Niraj Shah:

Sure. On your first question about average order value, what I would say there is kind of two different things. One is it does bounce around some, so I realize that is not a super gratifying answer, but there is some truth in that.

The second, specifically there is some seasonality, right? So that is a piece of it. The other thing is we did have an exceptionally strong outdoor season and outdoor furniture does tend to pull of the average order value, but obviously we had outdoor season last year but we had a very good season this year, so that helps. But it will—I think just from an expectation standpoint, it will bounce around a little bit and so that's why we have tried to say obviously that's a number you can always derive because we give you the number of orders and revenue. We try to focus you on not focus on that as a particularly key metric because that's more just an outcome of everything else that's happened versus something we are trying to deliver at any particular number.

In terms of your second question, which I think was around what is driving purchase frequency, purchase frequency I think is being driven up by a few things. One is the increasing brand strength where we are becoming a customer's go-to for more and more things. Obviously as we are doing more and more with personalization that obviously is helping us be more relevant to customers. I think that helps drive it up. We are doing more with seasonal events and seasonal merchandising which helps us be relevant obviously, which helps as well. Then there's certain categories where we've been pushing into, like seasonal décor, decorative accents and some other categories that historically have not been as big for us that we think have a naturally higher frequency than the categories we are strong and obviously that will help as we become the go-to in categories we are known for and then we add category strength in categories we are less known for.

Deb Schwartz:

Great. Thanks, Niraj.

Male Speaker:

Thanks, Deb.

Operator:

The next question is coming from Michael Graham with Canaccord Genuity. Your line is open.

Austin Moldow:

Hi, it's Austin on for Mike. Are you able to give any guidance around ad spend leverage like you have done in past two quarters, and maybe what you are expecting? Then I know you have mentioned a little in the past but can you update on the ad spend, the split between existing versus new customers and how that is changing maybe? Thanks.

Michael Fleisher:

Sure Austin, it's Michael. I think the best way to say it on ad spend in terms of going forward is we continue to expect annual sort of year-over-year improvement and I think you will see that. You've seen that the last two quarters and I think that will continue, but we are not going to guide it more tightly than that. And then I would say the other—what was the second part of your question?

Austin Moldow:

Just on the split between existing and new customer ad spend.

Michael Fleisher:

As we talked about before, we obviously spend a lot less to get a customer to come back and buy again. Obviously you can see the mix in our business, the orders from repeat customers is up again this quarter and so obviously there's a bigger mix there as well because that's where we are spending it, but we spend a much lower percentage of revenue to get a customer to come back than obviously bringing a new customer into the fold.

Operator:

The next question is from John Blackledge with Cowen and Company. Your line is open.

John Blackledge:

Great, thanks. A couple of questions. For private label goods, how do you determine which types of goods to offer and how should we think about the rising mix of public label SKUs over time? Also, if you can comment on the differential for private label. Then another question would be just remind us of the long-term EBITDA margin profile and any particular changes with the business growing better. Thank you.

Niraj Shah:

Sure John, it's Niraj. On private label, what I'd say there is that we are taking a fairly aggressive approach in private label. In terms of what types of goods, I would say the main area we are focused on is furniture and décor. So by that I mean, we are not focused on plumbing fixtures or flooring or some of our home improvement renovation areas. We are doing a small amount in housewares, but in furniture and décor we are fairly broadly aggressively going after private label, meaning a wide variety of styles as well as a wide variety of categories.

It's important to note private label for us is slightly different than for others because the way we scale it is we do not take inventory. The not taking inventory and the breadth of our supplier relations let us do more in parallel at a much faster speed and because we are not taking inventory, obviously it changes the cash dynamics of being aggressive in private label. We believe having a much bigger selection is far more powerful than having a narrow selection. That's a key tenet of our private label strategy. So long story short, we are going pretty aggressively after it.

In terms of margin, what I would say there is the margin profile of private label is meant to be higher. It's one of the reason the gross margin will rise over time than the gross margin of our in-line goods, but the main goal of private label is not necessarily to maximize margin, so it's not—we are not—we are really trying to shift the business increasingly to up this broad assortment that's private label, but we're not necessarily—some folks talk about how it's 20 percentage points higher in private label or something like that. We are not trying to get anything like that. It's a much more modest increase.

Michael Fleisher:

The third part of your question, nothing has changed in the long-term EBITDA margin goals of 8 to 10% and I think everything we are seeing in the business gives us continued confidence that that's the right place to be targeting long term.

John Blackledge:

Thanks so much. Thank you.

Operator:

Our next question is coming from Oliver Wintermantel with Evercore. Your line is open.

Oliver Wintermantel:

Good morning, guys. Can you talk a little bit about seasoning of the repeat customer, or in other words how did your repeat customers last year behave compared to the relatively new this seasoned customer—repeat customers? I'm talking about frequency and the average spend?

Niraj Shah:

So, you know, we have a chart that we put out in the past and we continue to update it periodically—and so the next time we put it out we will update it—where we show different cohorts and their spending over time. On that chart, what you do is you see a clear market increase from year-to-year, meaning the 2011 cohorts are lower overall periods going out that the 2012. We launched the brand in late 2011, right? Then 2013 are higher than '12; '14 is higher than '13. The thing you will see the next time we update it is that '15 is higher than '14 and the trends continues. So the shift we had an advertising to acquire higher value customers we think has been—worked very well. It's been very productive, but it's also been augmented by the fact that the site experience get stronger, the delivery network keeps getting stronger, the merchandising keeps getting stronger, the brand keeps getting stronger. So long story short, we sort of expect this trend to continue.

Oliver Wintermantel:

Okay. Great. Then I just have a—on the customer acquisition cost, by our math it's down about 8% in the first quarter and down another 8% in the second quarter. That low to mid $60 range (ph), do you think that's sustainable for the second half and going forward, or are any specific drivers that should change that going forward?

Niraj Shah:

So we sort of gave out them method to calculate that and we did that just to try to show that in this very conservative calculation, customer acquisition costs is effectively flattish is the way I would describe it. So while it's bouncing around, it's bouncing around in a range that effectively makes it look flat overtime in our view.

What I would tell you that in truth that's not a great way to calculate it because what you are doing is you are taking the brand spend on TV, that $40-odd million a year, you're taking the money being spent, the low percentage ad costs, money being spent on repeat customers, and you're putting all of that in with the money spent for new customers and putting it all against just new customer acquisition, which obviously is not an entirely great way to look at it but it's a very conservative way of looking at it and when you look at that way and you see that payback is effectively that kind of one-year timeframe, it gives you comfort that we sort of have the horizon in sight. So but I tell you we expect that number to be kind of flattish in the same way it's been flattish since the beginning of ‘14. But what we would tell you is the way we manage it internally is more nuanced than that.

Oliver Wintermantel:

Thanks very much.

Male Speaker:

Thanks, Oliver.

Operator:

The next question from Paul Bieber with Bank of America Merrill Lynch. Your line is open.

Paul Bieber:

Good morning. Thank you for taking my questions. First off, can you provide color on the active customer acceleration? Are we seeing the strength from several quarters of TV advertising or are you finding more efficient online marketing channels?

Niraj Shah:

Hey Paul, it’s Niraj. Obviously the brand getting stronger helps everything, but one thing I will point out, just remember our advertising cost is by and large being spent a new customer acquisitions, so only a small portion of it is repeat customer oriented and that $40 million which sounds like a lot of money for TV in some respects is not very much when you look at the overall size of our business and the overall money we spend on advertising. So we spend a fair amount of money getting new customers. It’s being very productive and so we are getting a great number of new customers. In truth, the number of actually customers we have is still pretty small over; it’s just over 4 million. So what I would tell you is we still think there's a lot of running room before there's any sort headwinds on us getting the next set of customers, because we think there's about 60 million customers for whom we would be a great fit in the US alone. So we think that it's still early days in that regard.

Paul Bieber:

Okay, and one quick follow-up. I think last Q4 you benefited from some very strong merchandising execution. Any big plans for this holiday season from a merchandising perspective?

Niraj Shah:

We always have big plans. We have ambitious plans, and, you know, when we report Q4 with the benefit of hindsight, we will be able to tell you how it went. But we think we are still—we think there's a lot of opportunity on many axes and merchandising is certainly one of them.

We are setting up a relatively large photo studio just outside of Boston, a 50,000 square foot studio that opens very shortly. There's a lot we are going to keep investing in, in kind of the right merchandising and the right product assortment, the right kind of technology on the site to make a great shopping experience whether you’re using a browser or the app, as well as what we do for visual imagery and all of this. So yes, we think we are excited about what we're doing with holiday.

Paul Bieber:

Okay, thanks. Great quarter.

Male Speaker:

Thanks, Paul.

Operator:

The next question is from Mark May with Citi. Your line is open.

Mark May:

Thanks for taking my question. Appreciate it. Two, if I could. Just want to clarify, I believe in Michael's prepared remarks he guided to not expect kind of further margin improvement—gross margin improvement from here. I think the timing was maybe in the second half, but with your aggressive focus on private label and scale benefits on shipping costs that you referenced earlier, just wondering why wouldn't you continue to see gross margin expansion even in the near term? Then secondly, I think your recent marketing initiatives clearly appear to be paying off, including more efficient acquisition, but you alluded to a possible deleverage in the second half in your guidance. Just curious why you would expect the recent ad spend leverage trend that you've been seeing of late not to continue in the second half. Are there some specific changes in channel or other initiatives that you are expecting? Thanks.

Michael Fleisher:

Thanks, Mark. On the ad spend side, to be clear, we expect to see continued leverage year-over-year. I was really more talking to not expecting sequential ad spend leverage. But year-over-year, as we said all along, we expect to continue to see ad spend leverage throughout the course of the year including in the back half.

On the gross margin question, yes, as we scale, there's gross margin opportunity and the private label products create that as well, but again as we've said all along, our goal is to create gross margin improvement and then share some of that back with the customer and when we think about our long-term growth strategy and what we're trying to drive as the business, that sharing is a super important piece of that. So we are tightly targeted in that sort of high 23's, low to mid- 24's as the place where gross margin should be. It's obviously crept up some now because of some of those benefits and now we will give some of that back to the customer, and that's the way we've handled it over the last several years and will continue to do that going forward as we work toward those long-term gross margin percentage of 25 to 27%.

Mark May:

Michael, if I just could follow up on that? The way you're giving that back, is that through pricing, like product pricing, or is it other initiatives? I assume it's mostly on product pricing. Do you need to do that? Do you see competitors that are coming in with more lower, more aggressive pricing or what's the—why do you feel the need to sort of give back or lower prices, I guess?

Niraj Shah:

Hey Mark, it's Niraj. If not really competitive. As you can see in this last quarter, we just had pretty high gross margin relative to what we've had in the recent past and we had pretty large revenue growth acceleration, right? So obviously pricing was critical to driving growth and the outcome we just had would see unlikely, right? So obviously what you are seeing is that you can have higher gross margin and significantly inflect up the growth weight while getting the marketing costs to come down significantly. But, you know, our view, we kind of take a long-term view and so there are certain things that we think would be nice long-term boons for the business and sometimes that's the way in which you might use pricing in a relatively new category where you don't yet have supplier leverage. There might be certain things you want to do on the transportation logistics side that in the long run save you money, but when you first roll it out in the immediate near-term you don't have it fully rolled out to where you have the efficiency gains right away. So there's a series of things you do that kind of keep playing for the long-term big wins, but are opportunities in the near term to accelerate that where it may cost you a little bit of money. So it's a mix of things, but it's not really competitive reaction on pricing.

Mark May:

Great. Congrats.

Male Speaker:

Thanks, Mark.

Operator:

The last question is from Aaron Kessler with Raymond James. Your line is open.

Aaron Kessler:

Hi, guys. A couple of questions and good quarter. First, from a marketing perspective to existing customers, anything you're changing on your end to maybe increase repeat purchase behavior such as maybe different types of e-mail marketing? Second, any sense that the business is becoming maybe more seasonal? I know you historically have said that it's that seasonal but we saw both 19% sequential growth and I think that was much stronger than last year. Any vertical specifically driving the stronger growth in Q2? I think you mentioned outdoor furniture. Anything else? Thank you.

Niraj Shah:

I think, Aaron, on the marketing side, there really isn't anything that has sort of changed. I do think all the work we've been doing and the investments we've made around personalization, all the work we're doing and investment we've made in sort of the site experience and sort of how we are communicating and talking to that existing customer, I think we are seeing the benefit of all of that hard work by all of our folks. I don't think that there's anything that's changing in terms of seasonality. I think as we've talked about before, we are getting better and better at sort of taking advantage of seasonal promotional opportunities, but I don't think that that's going to sort of dramatically change the mix quarter to quarter of the business from a seasonality perspective.

Aaron Kessler:

Got it. Finally, I noticed the Operations, Tech and G&A was probably the biggest increase on your expense lines. I know you talked about increased hiring there. Anything specific you would point to in terms of driving the higher expenses across that category?

Niraj Shah:

No, I think that obviously one of the most important investments we are making is continuing to add engineers and grow the sort of technology base of our business. That's what really sort of powers and undermines the whole business. Then also continued investments in the sort of operations side of the business, all of the delivery and logistics and all of that as well. So all of that should up, Aaron. It's an important place to be investing.

Aaron Kessler:

Okay, great. Thanks a lot.

Niraj Shah:

Thanks everyone for joining us for the call and look forward to talking to next quarter. Take care. Bye everyone.

Operator:

Ladies and gentlemen, this concludes today's conference call. You may now disconnect.