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Wayfair, Inc. (W)

Q3 2017 Earnings Call

CORPORATE PARTICIPANTS

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

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

Steven K. Conine
Co-Founder, Co-Chairman, Wayfair, Inc.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

OTHER PARTICIPANTS

John Blackledge
Analyst, Cowen & Co. LLC

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Seth M. Basham
Analyst, Wedbush Securities, Inc.

Justin Post
Analyst, Bank of America Merrill Lynch

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Aaron M. Kessler
Analyst, Raymond James & Associates, Inc.

Mark A. May
Analyst, Citigroup Global Markets, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen. My name is Julie and I will be your host operator on this call. At this time, I'd like to welcome everyone to the Wayfair Q3 2017 Earnings Release and Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

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

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

Good morning, and thank you for joining us. Today we will review our third quarter 2017 results. With me are Niraj Shah, Co-Founder, Chief Executive Officer and Co-Chairman; Steve Conine, Co-Founder and Co-Chairman; and Michael Fleisher, Chief Financial Officer. We will all be available for Q&A following today's prepared remarks.

I would like to remind you that we will make forward-looking statements during this call regarding future events and financial performance, including guidance for the fourth quarter of 2017. 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 10-K for 2016 and our subsequent SEC filings identify certain factors that could cause the company's actual results to differ materially from those projected in any forward-looking statements made today. Except as required by law, we undertake no 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.

Now I'd like to turn the call over to Niraj.

Niraj S. Shah

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

Thanks, Julia, and thank you all for joining us this morning. In Q3, Direct Retail revenue was up 42% year-over-year, with total net revenue growing by 39% year-over-year. This represents year-over-year dollar growth of approximately $350 million in the Direct Retail business. We saw continued growth in both our U.S. and International businesses, with U.S. Direct Retail revenue up 36% versus Q3 last year and International Direct Retail revenue up 103% versus Q3 last year.

We are delighted to see our offering continue to engage more and more people with over 10 million shoppers buying from us over the last year and LTM revenue per active customer reaching an all-time high this quarter.

Today, I will provide brief updates across a few key areas of our business and then I'll turn it over to Steve and Michael before we take your questions. Last quarter I updated you on our International business and we remain very excited on the investments we're making there and the response we're seeing from customers in Canada, the UK and Germany.

Our continued strong growth in these markets and improvements in our International core KPIs give us great confidence in continuing the long-term investment cycle we're making there in the customer experience, advertising dollars and our teams.

Two other major strategic areas of focus that you've heard us talk a lot about that I want to focus on today are our growing house brands program and our transformational supply chain network, which is comprised of CastleGate and the Wayfair Delivery Network, or WDN. In Q3 we continued to build out our house brands offering in the U.S., Canada and Europe. We now have a portfolio of more than 70 house brands, and we're investing further in the visual imagery that is so important in helping our customers look for inspiration and find products that fit their taste.

In Q3, house brands grew to approximately 60% of Wayfair.com revenue. Up from approximately 45% in Q1 of this year. And we expect to continue to grow this penetration over time as we add more suppliers and more new product introductions from existing suppliers. On the earnings call last quarter, we highlighted the significant growth we have seen across our CastleGate fulfillment network. We continue to see the network develop in the U.S. and Europe as suppliers gain greater awareness of the benefits CastleGate can bring to their business. Both in terms of cost efficiencies and increased sales.

The proportion of our U.S. small parcel business being shipped from the CastleGate network continued to grow in Q3 and we will be targeting further growth in 2018.

As we outlined in our last call, we are not planning to open any new major CastleGate warehouses in 2017. But we do expect to do so next year as our business continues to scale and CastleGate penetration rises further.

This quarter, we'll add a smaller warehouse to our infrastructure in Europe when we open our first CastleGate facility in Germany, which will become operational in Q1 of next year, enabling the continued development of our offering to suppliers and shoppers in that market.

During Q3, we opened three WDN last-mile delivery facilities in Cleveland, Tampa and Denver, bringing the total to 15 facilities and giving us coverage of just over one-half of our U.S. large parcel home deliveries.

In 13 of these cities, we now offer customers the ability on the day of delivery to track the location of their Wayfair delivery driver in real-time through an interactive GPS map.

Turning to the middle-mile of our delivery network, in September, approximately 70% of our U.S. large parcel orders were flowing through the Wayfair-controlled middle-mile network of consolidation centers, cross docks and line haul.

This ongoing reduction in our reliance on third party operators enables us to increase delivery speeds, reduce damage and costs, and improve customer satisfaction across a greater and greater proportion of our business. We're pleased with the results that we are seeing in the markets where WDN last-mile facilities have been introduced. And we expect to continue rolling out additional facilities in 2018.

Michael will talk about Q4 in more detail later. As we move into the holiday season, I want to tell you more about how we approach promotions and how our business model enables us to innovate in bringing great offers to our customers. We run promotional events throughout the year and we're very analytical in how we plan across the business, often up to a year in advance, to put us in the best possible position to bring customers the products that we think will excite them at attractive price points.

Two aspects of our business enables us to take an approach to promotions that is different from other retailers. The first is that we run an inventory-light model. This allows us to be very nimble with our promotional events and react to customer behavior. We can also avoid the typical gross margin pressure of promotional events because suppliers offer us more attractive wholesale pricing when they expect the volume uplift associated with being part of a promotional event at Wayfair.

The second aspect is CastleGate. We work very closely with suppliers as we plan our promotional event, ensuring that they can maximize the opportunity of increased prominence on our site and that orders can be delivered quickly, which is particularly important in the holiday season.

By forward positioning supplier inventory in our warehouses, we are able to offer efficient delivery and, as a result, we can run creative promotions which benefit customers, suppliers and Wayfair.

One example of a promotional event we ran in Q4 last year was on holiday ornaments, where customers were able to select five ornaments from a large selection for $25 with free delivery. Traditionally, it would have been very expensive for a customer to pick five different ornaments shipping from different suppliers and have them delivered within one day to two days given the high shipping costs relative to the price of the ornaments. By working closely with our suppliers to have these products in our CastleGate warehouses, we were able to offer our customers the opportunity to create the exact set of ornaments they want from many different suppliers and have them shipped quickly in one convenient, affordable package.

Following the demand from customers in 2016, we have more than doubled the number of units in CastleGate for this promotion in 2017. We run engaging offers like this in other categories as well, such as the 3 for $30 bundles in kitchen utensils and a similar event in decor earlier this year. And we would not be able to offer the degree of choice and pricing that we do without the investment that we have made in CastleGate and the collaborative approach we take with our suppliers throughout the year.

It's been a year since we've updated you on our mobile app, so I'll briefly give you an update on our mobile capabilities before turning the call over to Steve. Giving our customers an exceptional shopping experience is central to everything we do at Wayfair. And making it convenient for shoppers to engage with our offering across devices is an increasingly important part of that. More than half the traffic to Wayfair.com now comes from mobile devices, and we're excited about the growth potential of the channel and continue to see it taking share. Our customers will often invest considerable time in creating looks that they love. And that means they may visit Wayfair sites across multiple devices, maybe discovering new styles on mobile web, saving items to their idea board on the mobile app while they're on the go and completing purchases at home from their home desktop computer. We see these different methods of engagement as great opportunities to showcase the many features of our offering to shoppers.

Mobile is already a substantial part of our business, with 45% of orders in Q3 completed on mobile devices, and we believe this share can grow significantly over time. With this expected growth in mobile penetration, we've been investing in our mobile capabilities to ensure we're offering shoppers the best customer experience in the market. For example, the integration of Apple Pay gives our customers greater choice in how to pay when using their phone or tablet. Our customer service teams also give shoppers a fast and convenient way to communicate with us via our mobile messaging service.

Over the last year, we've enhanced the performance of both our mobile app and mobile web experience to improve speed and reliability while still offering customers the visual imagery and shopping tools to help them find the perfect product. As we highlighted in our last call, we've been building our augmented reality capabilities for quite some time. And with the launch of iOS 11 in September, we're now able to offer app shoppers the opportunity to view tens of thousands of products in 3D in their own home.

With mobile increasingly becoming the preferred device of our shoppers, our team of over 1,200 engineers treat it as central to their work in building a shopping experience that is leading the way in eCommerce for the home. Turning to our mobile app, specifically where we have a dedicated team of engineers, on each iOS and Android, we're very pleased with the growth achieved over the last couple of years.

At the end of 2015, our app has been downloaded over 2 million times. And by the end of September of this year, that number exceeded 11 million. Not only are these shoppers choosing to put our app on their phones, but more importantly, they are using it. App visitors view many more products per session and convert at a higher rate compared to other visitors. This increased level of engagement is also reflected in purchase behavior with the average revenue of app visitors being over three times that of other visitors. We are excited to be bringing customers a great shopping experience regardless of the technology they happen to use. And we believe that with continued innovation, mobile will be a driving factor behind our future gains in market share.

Now I'll turn the call over to Steve to talk about our proprietary advertising technology stack.

Steven K. Conine

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

Thanks, Niraj. In previous calls, we have talked about our approach to advertising spend. And today I want to tell you more about the role that technology plays in how we market to new and existing customers. In the early days of Wayfair, we used both external agencies and in-house programs to create, deliver and track our marketing initiatives. As our business scaled, we saw compelling opportunities to take more and more of our marketing in-house by building our own advertising technology stack. And today, all our marketing spend is managed in-house leveraging our proprietary technology.

The investment in proprietary technology has equipped us not only to take costs out of the system by reducing the need to work with intermediaries, but also enabled us to be more effective in how we spend marketing dollars by giving us more control over the pace of innovation. We have a team of more than 60 engineers and data scientists dedicated to supporting this technology infrastructure, equipping us to effectively execute and innovate continuously.

Paid search is one channel that is often outsourced by eCommerce businesses to agencies given the analytical complexity and competitive pressures inherent in the channel. In 2014, we took all our paid search activity in-house. As our marketing team is managing this platform internally, we can utilize our wealth of historical intelligence on the 20 million or more keywords that we may be bidding on to predict the value of that traffic more accurately and hone our bidding tactics accordingly.

When searching for a furniture or decor product for the home, the purchase decision is often one of high consideration with customers browsing widely before completing an order. If a customer has browsed on Wayfair but not yet placed an order, we are able to continue to market to that customer with personalized and relevant product suggestions based on both past order history and browsing behavior.

We combine both first and third party data in our proprietary bidding algorithm to determine how much we're willing to pay to serve an ad to an individual customer. This technology allows us to determine the optimal product set to serve that customer in the [ph] retarding (15:55) ad itself. Our in-house server enables this personalization – this personalized ad to be delivered in less than 40 milliseconds. This technology gives us a level of confidence in our marketing spend decisions that third party systems couldn't. The scale of both our product range and our customer base means that our algorithms are continually improving via testing and machine learning and will become more and more impactful over time.

The shoppers that we can most cost effectively market to are the millions of customers that have shopped with us before. And we've developed a platform that enables us to personalize our interactions with this growing group. Our recommendation service will determine the ideal product, sale event, or message to highlight to each individual customer based on the highly tuned view we've built of them. The investment we've made in this CRM technology stack means that we can give our customers a highly personalized experience across marketing channels. And when they are on-site, make it easier to connect them with products they'll love.

While we have invested considerable resources in building our own ad technology platforms internally, we have also been working closely with businesses that are innovative in online marketing.

We've developed deep partnerships with Facebook, Google, Pinterest, and others that have enabled us to be at the forefront of new targeting techniques and influencing their roadmaps, generating mutual benefits. We believe the investments we've been making in our marketing capabilities put us at the leading edge of eCommerce marketing. We're generating considerable benefits today from the strategic decision to build rather than buy our marketing technology. And we're excited by the future gains that lie ahead.

I'll now turn the call over to Michael to talk about Q3 financials in detail.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

Thanks, Steve, and good morning, everyone. I'll 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 Q3, our Direct Retail business increased 42% year-over-year to $1.181 billion representing year-over-year dollar growth of approximately $350 million. Our total net revenue increased 39% year-over-year to $1.198 billion. Our Other business, which primarily includes revenue from our retail partners, but also includes revenue from our small media business, decreased as expected to $17 million as we continue to scale down our retail partner business.

Our KPIs which we report on a consolidated global basis continued at strong levels in Q3. Many at all-time highs. LTM active customers increased to 10.3 million customers, up 39% year-over-year, and up 703,000 net new active customers sequentially versus Q2.

Purchase frequency, as measured by LTM orders per active customer, continued the growth we've seen in each quarter of this year to a new high of 1.75. Average order value for the quarter was $250.

In the U.S., our Direct Retail business increased to $1.034 billion in Q3, up 36% year-over-year. This represents year-over-year dollar growth in the quarter of approximately $275 million in U.S. Direct Retail revenue. Internationally, Direct Retail revenue from our Canadian, UK and German businesses collectively increased to $148 million, up 103% versus Q3 last year. In our International business, we are benefiting from continued growth in the proportion of orders from repeat customers and we're excited by the opportunity to ramp our overall penetration in these markets in the future. I will share the remaining financials on a non-GAAP basis, excluding the impact of equity-based compensation and related taxes, which totaled $20 million in Q3 2017. For a reconciliation of GAAP to non-GAAP reporting, please refer to our earnings release on our IR site.

Our gross profit for the quarter, which is net of all product costs, delivery and fulfillment expenses, was $281 million or 23.4% of net revenue. On the Q2 call, I described how the strength of our customer conversion and repeat rates was opening up further opportunities to invest in advertising inventory, while remaining within our one-year payback threshold. In Q3, we continued to spend fully up to our target payback days, resulting in advertising spend of $142 million in the quarter or 11.8% of net revenue which was in line with our expectations.

Looking out to Q4, we expect to continue investing ad dollars in the high ROI opportunities we are seeing. And anticipate ad spend as a percent of net revenue in the fourth quarter to be flat or slightly above the 11.8% level of Q4 last year.

Our non-GAAP merchandising marketing and sales expense and operations technology and G&A expense are driven primarily by compensation costs. In Q3, these two line items combined were $141 million. Excluding the approximately $10 million impact of one-time charges related to terminating the use of our warehouse in Ogden, Utah in July 2017. Unfortunately, the Utah location, which we chose originally in 2011, was no longer efficient following the build-out of our full logistics network across the country. We do not currently anticipate any further warehouse closures.

In the third quarter, we added 841 net new employees for a total of 6,890 employees as of September 30, 2017. As I outlined on the previous earnings call, we are continuing to ramp up our hiring. And we're excited to be adding great people to our teams across the business. Approximately 300 of the net new employees in Q3 were in OpEx areas, such as marketing, merchandising, operations and technology, compared with approximately 160 net new employees added in those areas last quarter.

The ramp in hiring is expected to continue into Q4 as we reach a more normalized rate of net new hires following the low rate of hiring in the second half of 2016 and early 2017. The increase in variable head count of approximately 550 employees was primarily in our customer service operations, and we expect to continue to build head count in this area and in our warehouses in line with our continued growth and in advance of the holiday season. Scaling our teams is central to delivering in the three main investment areas we've spoken about previously, namely, building out our International capabilities, developing our proprietary logistics network and increasing penetration of priority product categories. We're pleased to have entered Q4 with strong momentum in building our teams across these areas.

As we've said in the past, as a result of the ongoing build-out of our CastleGate and WDN facilities, unutilized rent continues to weigh on our P&L in the $5 million to $7 million range per quarter in our OTG&A line. Adjusted EBITDA for the third quarter was negative $23 million or negative 1.9% of net revenue. Adjusted EBITDA for the U.S. business in Q3 was positive $5 million, in line with our expectations of positive EBITDA for the quarter. As a reminder, this is the fourth consecutive quarter of adjusted EBITDA profitability in our U.S. business. Adjusted EBITDA in Q3 for the International business was negative $27 million, which was consistent with the losses we have seen and expected internationally in recent quarters as we scale our business outside of the U.S.

Non-GAAP free cash flow for the quarter was negative $18 million, based on net cash from operating activities of $25 million and capital expenditures of $43 million. CapEx spending was 3.6% of net revenue this quarter. For Q4, we expect CapEx to be approximately 3% of net revenue, resulting in a total 2017 CapEx of approximately 3% of net revenue.

As of September 30, we had approximately $640 million of cash, cash equivalents and short and long-term investments. This amount reflects approximately $376 million from the issuance in September of convertible notes, net of all fees and the cost of the capped call transaction. This funding further strengthened our balance sheet with attractive, low-cost 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 let me turn to guidance for Q4 2017. We forecast Direct Retail revenue of $1.315 billion to $1.340 billion, a growth rate of approximately 37% to 40% year-over-year and representing year-over-year Direct Retail dollar growth of approximately $350 million to $380 million. Within that, we expect U.S. Direct Retail year-over-year growth in the range of 33% to 35% and International Direct Retail year-over-year growth in the range of 75% to 85%. To give transparency on current trending as I've done previously, our Direct Retail gross revenue quarter-to-date is growing above 40% year-over-year.

As always, we are prudent when we set revenue guidance and the fourth quarter in particular has a heavier weighting to the back half of the quarter, due to the holidays. Overall, our guidance for Q4 points to another strong quarter of growth and we continue to be pleased with the market share we are gaining. We forecast other revenue to be between $15 million to $20 million. For total net revenue of $1.330 billion to $1.360 billion for the fourth quarter.

For consolidated adjusted EBITDA, we forecast margins of negative 1.7% to negative 2% for Q4 2017. We expect International adjusted EBITDA losses to be plus or minus $30 million in Q4, and the U.S. business to deliver similar adjusted EBITDA dollars to Q3 2017.

In Q4, we remain incredibly bullish about our business both in the near term and long-term. Our customer KPIs continue to be strong. We delivered another quarter of approximately $350 million in year-over-year dollar growth in Direct Retail and Q3 marks the fourth consecutive quarter of adjusted EBITDA profitability in the U.S. Given the strength of the business and the large opportunity we see ahead, we plan to continue investing, including taking advantage of ad spend up to our one-year payback target and the continued build out of our teams across the business.

For modeling purposes for Q4 2017, please assume equity based compensation and related tax expense of approximately $22 million to $23 million, average weighted shares outstanding of 87.9 million, and depreciation and amortization of approximately $22 million to $24 million.

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

Niraj S. Shah

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

Thanks, Michael. Steve and I are extremely proud of the headway our company of just under 7,000 people is making in transforming how customers shop for their home. While our year-over-year growth rate in Direct Retail revenue was 42% in Q3, I want to point out that this represents $1.2 billion of growth in Direct Retail revenue in the 12 months ending September 30.

To just put that into context, our Direct Retail revenue in the full year of 2014, which is the year we went public, it was only $1.1 billion. Now, less than three years later, we've grown our business by more than that amount in a single year and we've reached a revenue run rate of just shy of $5 billion. As dollars in the home category continue to move online, we believe we can keep taking an outsize share by delivering the best customer experience with vast selection, inspiring visual merchandising, fast and convenient delivery, and world class customer service.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first questions comes from the line of John Blackledge from Cowen. John, your line is now open.

John Blackledge
Analyst, Cowen & Co. LLC

Q

Great. Thank you. Just a couple questions. The repeat rate at 61% was a bit lower than we expected. A touch below Q2 2017 levels. Any call out here? And could you discuss perhaps the difference in repeat rates between U.S. and International? And do you kind of view generally repeat rate as a critical component of long-term leverage in the business? And then I have one follow-up on the EBITDA guidance.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

Yeah. Thanks, John. The – yeah, the orders from repeat customers. Remember on that metric, as I try to point out to everybody, right? It's a combination of how many orders are coming from repeat customers, but also how many new customers are coming in, right? And we obviously had a good quarter from adding new customers. So, I feel quite good about that. There's also always some seasonality to that as well. So, I think, it's basically the same as it was last quarter.

And I think, the other metric that I would focus people on when they're thinking about repeat is really looking at that 1.75 orders per active customer. And as you pointed out, we know that the International business, right, runs well below that, and the International business is continuing to gain share. We don't break out the number between units in International, but the U.S. business is running at a repeat rate far better than that 1.75. And that number, the 1.75, is an all-time high. And the U.S. business is at an all-time high.

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

A

And, John. This is Niraj. So just to clarify, the 61% is not the repeat rate, it's the share of the orders that are repeat orders. And then the closer that you get to a repeat rate is what Michael was referring to, where you drive the number of orders per customer, which would be an indication of frequency.

John Blackledge
Analyst, Cowen & Co. LLC

Q

Okay. Great. And on the U.S. EBITDA guide, it's typically the margin, at least the last couple years, was the highest in 4Q, given – perhaps given the seasonality of, I think, margins, given Michael's guidance, it's going to decline a little bit. Maybe you could just give any call outs or further details on the U.S. EBITDA guidance?

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

A

Sure. Since it's guidance, I'm going to let Michael answer it.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

So, John, I think that we talked a lot last quarter about trying to guide gross margin. In particular, I think, as you go into Q4 with more of the revenue in front of us than behind us in a typical quarter. And so, I think that's – there's that piece, and I think the other piece that you – we always take into account in Q4, and I think, if you went back and looked at our Q3 call for the last couple years you'd hear me say the same thing which is, it's very hard to anticipate what the promotional environment is going to look like in fourth quarter going into the holiday. We always anticipate that it's going to be intense. In some years it's been super intense, and some years it's been less-so.

You'll remember though, that the way we build our business – when other folks are being promotional, right? They haven't – they own that product already. Right? They've bought that product in an inventory and then have to go discount it and sell it at a much lower gross margin. That's not our business model, but at the same time, we still got – we still work very hard to be market-priced, and so we want to leave ourselves the room to make sure that, from a gross margin perspective, we can sort of do the right thing for our customers in that period.

John Blackledge
Analyst, Cowen & Co. LLC

Q

Thank you.

Operator: Your next question comes from the line of Peter Keith from Piper Jaffray. Peter, your line is now open.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Hi. Thanks. Good morning, everyone. Thanks for all the detail on the call. Was curious during the third quarter, with the hurricane dynamics that other companies have called out here in recent weeks, did you guys see any impact on your business, perhaps in late August or parts of September?

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

A

Sure. Peter, yeah, I mean, when any time you have events like that, there's no question that when you look at sales in the states impacted and so on and so forth, you definitely see kind of dislocation from recent trends. That said, the one thing I do want to point out, our business, when you think about the total business growing over 40% and the overall market only growing a couple percent, a couple few percent, really the obvious, biggest thing that's happening is there's a secular shift to online from offline. So offline, you know, total market is growing 2%, 3%; offline's growing less than that. Online is growing 15% and then we're growing over 40% relative to the 15%.

So what happens is we do see those affects, because those macro effects are so large. But their impact to us in total from a quantitative basis is heavily muted by that secular shift. But we definitely see the trend where there's a little bit of freezing up and then there's a rebound and the same kind of trends others would see.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay. Thanks, guys. And one quick follow-up then, the – just looking at how you had guided Q3, it looks like you exceeded your sales guidance, but then the EBITDA margin came in at the midpoint. Was there any expense line items that came in a little bit heavier than you thought?

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

Hey, Peter. It's Michael. A couple thoughts there. One is, as I mentioned in my prepared remarks, we feel really good about the hiring and the pace at which we're hiring, and so that stepped up quite dramatically in the quarter. And I think that was – so I think, the OpEx head count adds were probably a little more than we anticipated.

I would also note that, as I talked about, the customer unit economics continue to be very strong, right? That 1.75 orders per active customer, the $408 trailing 12-months revenue per active customer. Which means that from an ad spend perspective, we've continued to be leaning forward because every dollar of ad spend, we're spending, is getting us a really strong customer at this point.

So, I think, the combination of those two, plus as I pointed out last time, right, trying to sort of pinpoint gross margin is a complex task in our business based on the nature of our business model. And so movement of 10 basis points or 20 basis points seems like sort of super-fine detail.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay. Good enough, and good luck with the holiday season.

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

A

Thanks, Peter.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

Thanks, Peter.

Operator: Your next question comes from the line of Seth Basham from Wedbush. Seth, your line is now open.

Seth M. Basham
Analyst, Wedbush Securities, Inc.

Q

Thanks a lot, and good morning.

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

A

Hey, Seth.

Seth M. Basham
Analyst, Wedbush Securities, Inc.

Q

My question is around customer acquisition costs. They seemed to have picked up a bit. Obviously, you were leaning in on advertising, you are investing to drive growth up to that one-year payback period. But at this point, how long should we be expecting customer acquisition costs to remain in this relatively elevated rate?

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

A

Hi, Seth. This is Niraj. Yeah. So I guess to kind of – I guess, try to help explain the customer acquisition costs, I don't know that it'd be fair to characterize it as elevated. I think basically, what you have is that earlier in the first question, we talked about that 61%, the mix of repeat orders relative to new orders. As the business increasingly – there's two mix effects that are happening in the business. One is an impact of the business shifting increasingly to repeat versus new, and the second is the mix of International relative to domestic. And if you isolate for those mix effects, you would see something different.

The calculation that we gave you years ago, where we say, take every dollar of ad spend and hit the new with it, that obviously becomes a less effective proxy method as new becomes a smaller portion of the total because you're taking the very efficient ad spend that's for the repeat base that runs at a low percentage of revenue, and – but you're counting that as zero percentage of revenue. You're taking those dollars which are growing larger in absolute dollar terms and hitting the new base with those larger and larger dollar amounts, which would then do what you said, which would make it look like it's rising when in fact on a unit basis, new customer acquisition costs are not necessarily changing in the way that you're seeing.

So I think as you model it going forward, you need to start assuming or I don't want to say how to model it, but one way you could model it is to start to put in what we talk about, which is like this notion that repeat revenue runs at a very efficient ad cost but it's a low percentage of revenue, but don't run it at zero. And then that would let you, I think, get closer to a proxy for customer acquisition costs.

Seth M. Basham
Analyst, Wedbush Securities, Inc.
Q

That's helpful. So just to be clear, in the U.S., Niraj, the customer acquisition costs are not rising on a year-over-year basis?

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.
A

I think the customer acquisition costs, Seth, have remained in that sort of – the calculation that we do at the back of the investor deck. That calculation that Niraj has pointed out why some of – there's some challenges with it as the business becomes more repeat. Those have run sort of between $65 and $75. And so – and at the same time, I would point out that's during a period of time when revenue per active customer has gone from basically $350 to over $400.

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

This is Niraj. Just to say it a different way, I guess. The ad efficiency, so the time to get the payback has not changed in the domestic business. So if you think about the – the key thing on the ad cost is how long until the cohort breaks even. And I think what gets dangerous is when you start extending the period you're allowing it to have, where the value of the contribution margin from the cohort covers off the ad cost when you elongate that. And we have not changed that and in actual numbers it has not been extended. And I think that's kind of what you want to get at. So then the math you're doing, basically, I tried to explain to you how you can get to seeing that in terms of understanding the numbers, the actual numbers, as well as possible given what we've given.

Seth M. Basham
Analyst, Wedbush Securities, Inc.
Q

Fair enough. Thank you, guys, and good luck with the holidays.

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

A

Thanks, Seth.

Steven K. Conine
Co-Founder, Co-Chairman, Wayfair, Inc.

A

Thanks, Seth.

Operator: Your next question comes from the line of Justin Post from Merrill Lynch. Justin, your line is open.

Justin Post
Analyst, Bank of America Merrill Lynch

Q

Great. Thank you. I guess a lot of questions on customer acquisition costs. On a high level, when do you start seeing real leverage in that line, especially on the U.S. side? You're not seeing it in the bottom line guidance at this point. So can you talk about when you're going to start seeing leverage there? And then the second thing, a lot of questions out there about perhaps your largest long-term competitor getting more aggressive in product listing ads and other areas. So are you seeing ad costs go up on a unit basis, and how do you feel about competition? Thank you.

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

A

Yes. Sure, Justin. It's Niraj. So what I'd say is, I mean, this is what you're seeing in our numbers. You could see our rate of growth, like the online market's growing at 15% and we've got a U.S. direct business growing at a multiple of that tells you that we're net taking share. We do not see ad costs on a unit basis really going up. And I think that a lot of that is frankly due to the fact that our brand is getting stronger, the experience is getting stronger, and we've built our own ad tech, and Steve spoke to that earlier, but basically that gives us a very significant advantage in terms of efficiency on the advertising side.

So I think the thing about seeing efficiency in the advertising line, I think there's like a misconception because basically the ad costs could drop dramatically overnight if we were willing to not acquire new customers that have great economics and instead just try to grow at the market rate of 15%. Effectively we wouldn't really need to spend very much money. If you could get customers, though, and they're going to pay back in less than a year and they're going to show productivity that's in – if you look at the [ph] cohorts trends, it's (42:47) better than any time in the past, it seems to us a little bit foolish not to want to acquire that customer.

If you then take the cost to acquire that customer and expect the revenue to have shown up magically overnight, then of course it's not going to work, and that's effectively the analysis you're referring to where you're taking the current period revenue and then the acquisition costs for all these new customers, and you're saying, 'Well, it should have paid back overnight.' Whereas the leverage and you're discounting the growth rate, which is effectively showing you that these new cohorts paying back over time on the cohort chart we give you, which shows you the monetization curve.

So the way to, I think, think about it is if you can segment sort of the ad costs for repeat from the ad costs for new, understand the payback period on ad costs for new, effectively you have great economics on cohort basis for new customer acquisition, paying back in the same timeframe on stronger revenue productivity curve, stronger repeat than you've ever had before. And effectively, that's a very high return on investment.

So that's sort of the way we think about it. And so the U.S. ad cost, remember, too, the international sort of delevers that percentage, right. So when you look at the total percentage, in this case, [indiscernible] (43:58) was flat year-over-year, obviously the U.S. would have been – the U.S. has to be a beneficiary, a contributor, if the international is a negative contributor, if the total is flat, and the international is taking share. So the U.S. actually does show leverage, but to be honest, that's not what we manage it for. We manage it for what I was talking about a minute ago, which is just making sure that we want to be ambitious in getting customers, but we don't want to extend the payback period. We want to make sure customers are really high value and we want to be very quantitative about that. So that's kind of the way we think about it.

The second question you had was specific to Amazon. I'm assuming that's who you were alluding to. And what I would say there, they're obviously someone who wants to own all physical goods ecommerce, but the same challenges I think that they've always had in home, they still have. So if you look at our selection, our merchandising, the distribution logistics capability we've built for these large, bulky, heavy items, the in-home delivery operations, the customer service, these are all significant advantages and I think speak to why our brand continues to gain strength in home.

So I don't expect them to go away, but if you look through the pages on their site of the way their volume is, it's all the commodity opening price point items, same place where Walmart and Target play. And I think they're going to continue to be a player there. But, again, as you move off that very bottom into the mid, I think that's where you're seeing us continue to gain huge share and traction.

Justin Post
Analyst, Bank of America Merrill Lynch

Q

Okay. Thank you.

Steven K. Conine
Co-Founder, Co-Chairman, Wayfair, Inc.

A

Thanks, Justin.

Operator: Your next question comes from the line of Brian Nagel from Oppenheimer. Brian, your line is open.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Hi, good morning, and thanks for taking my question. So the first question I have, recognizing that growth at Wayfair is probably better than any other place out there, but that said the trajectory in revenue growth has been a bit choppy for the last few quarters or so, with Q2 strengthening significantly and Q3 moderating somewhat. As we look back at that, is there some takeaway as to why we had this [indiscernible] (46:05) that bump in Q2 and a slight moderation in Q3? To what extent, if you can explain, is that simply under your control and reflective of the decisions you're making in building the business?

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

A

Thanks, Brian. I think the way to think about what we care about is we care about the long-term outcomes. So in that sense, we're not trying to manage like quarterly percentages or quarterly results, per se. But what I will say the key number, I think, to look at is the dollar growth. And if you look at the dollar growth, you'll see that the direct business had $350 million and it's come back up after a period where it did slip down. And we talked about how when it slipped down, we believe that a lot of the hiring we did a year and a half ago was a lot, all at once, and we had a lot of different initiatives, and frankly, we're seeing those really pay off. But it created a period of time where our execution we don't think was necessarily as tight as we wanted.

Now if you look at what's happened, where some time the caliber of the talent we've hired is we think incredibly strong, and the execution naturally gets a little bit tighter over time. It's helped us learn how to scale the head count in a wiser way, which we're now taking advantage of. And, frankly, when you see the dollar growth is basically an all-time high. What I would tell you to look for is if we do a good job, this dollar growth will not exactly on a linear track, it should continue to grow. And that then depending on what happened a year ago in that same quarter gives you that year-over-year number, but that year-over-year number, it's fine if you're mature and the market is growing at 3% and you're growing at 7%, and you're saying 'In this mature market we're a share-taker,' but I don't think it works that well when you get a period of rapid change like what we have. So this is where we kind of tried to turn into the share of the dollars that came online and the dollar growth, these sort of derivatives that really try to point to whether we're being effective while protecting the unit economics and the inherent profitability of the investments we're making and succeeding in the eyes of the customer with that dollar growth. And that's what we play for and that's what we're excited to see working out really well.

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

Yeah. It's really helpful. Thank you. And then my follow-up question, Michael, you talked about the recent convert offering. The question I have there is, as we look at the deal and the capital that brought into the business, does that signal some type of maybe [indiscernible] (48:25) some shift you're going to make? Or is it simply just a cushion at this level?

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.
A

Yeah. I think it's the latter, Brian. I think we've tried to be really clear that this should not be read by anyone as doing anything but us taking advantage of a very strong convert market and raising some really attractive low-cost financing.

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

Got it. Thank you.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.
A

Thanks, Brian.

Operator: Your next question comes from the line of Aaron Kessler from Raymond James. Aaron, your line is now open.

Aaron M. Kessler
Analyst, Raymond James & Associates, Inc.
Q

Yes. Hi, guys. If you could just maybe provide us an update on some of the newer businesses, kind of how they're tracking such as the wedding registry. Sorry, if I missed that. And then if you can maybe just geographic performance by country, just how that's performing versus expectations. Thank you.

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

A

Great, Aaron. This is Niraj. Yeah. Wedding registry, we didn't touch on that. That just finished sort of its first year, so there's an annual cycle there where through fall and into the winter folks are getting engaged, they're setting up their registry for the coming kind of spring/summer wedding season. We had a good first year where the plans for how to acquire customers for this second year are rolling out now. So that's something that will take a little longer to build because it has that annual cycle to it, but we're sort of really happy with what we're seeing there.

We talked about Perigold I think a quarter ago. It's early days, but we're seeing really nice traction there. We've talked about different categories at different times in terms of – we've talked about mattresses, we've talked about decorative accents, we've talked about – we just finished the outdoor season, which we really had a spectacular season. So we've got a lot of different areas that are really building up, some of which are relatively new in terms of investing in and some of which are a little older but continue to gain strength.

We have other programs like our private label credit card and financing, which we've not given an update on in a while, but we will again sometime soon, but that continues to kind of continue to gain steam. So we've got a lot of different things we're very excited about. And what you're seeing is sort of the interplay of all of them, which is building the business really nicely and creating a lot of value for the customers.

In terms of your other question on geographic performance, in the International segment, we have three countries. We have Canada, the UK, and Germany, and they're at very different stages of maturity. Canada, because it effectively gets to write up the U.S. infrastructure, the U.S. merchandising, the U.S. selection, U.S. supply chain, it's gotten off to a very good start and it's ramped very quickly, and it continues to grow at a nice clip. So Canada is the most mature.

The UK, which is really the first market we focused on in Europe, has grown very nicely. So that's now in a state, where we've become a leader in that country from kind of organically building that and taking a while to get momentum to where now we have scale and it's growing very nicely and we're able to do some things. We talked about how we opened a CastleGate facility there a few quarters back and that's scaling. And so that's, sort of, in the medium level of maturity.

And then Germany is sort of at a very early level of maturity. And so there we've built up a team in Continental Europe that we feel like understands the market well. We've been building up the selection, the merchandising, and these are all predecessor activities to really getting to where we can then market the offering and really ramp the customer base. And so Germany is sort of the least mature. And when you kind of take all their numbers and add them up together, that effectively gives you that International segment.

Aaron M. Kessler
Analyst, Raymond James & Associates, Inc.

Q

Got it. Great. Thanks for the update.

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

A

Sure. Thanks, Aaron.

Operator: Our final question comes from the line of Mark May from Citi. Mark, your line is now open.

Mark A. May
Analyst, Citigroup Global Markets, Inc.

Q

Thanks. I kind of have a two-part question. One is as the business shifts more and more towards the in-house brands, I think you said 60% and growing, how does that impact some of the aspects of the business that we thought of kind of in the earlier days of Wayfair in terms of the levels of inventory, the service revenue opportunity at CastleGate, I'm sure there are a number of elements there. But just trying to understand how that shift kind of impacts some of those core elements of the business. And then kind of the second sub-question along those lines is, in terms of as you've built out the CastleGate network and are controlling more and more of the distribution for your customers, are you generating any meaningful CastleGate revenue and can you remind us where that shows up in the P&L? Thanks.

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

A

Okay. Great, Mark. Let me tackle the first one and then Michael can comment on the accounting and then I can share some thoughts on CastleGate for the second one. So on the first one, so here's the – the beauty of the way we're doing the house brands first. So you're right, we said it's up to 60% of Wayfair.com. So that's obviously the majority of the business. And there's certain categories where it's less relevant where there are brands in things like plumbing and large appliances, but the vast, vast majority of what we operate in are non-branded categories.

And so we've had great success building up these brands because they effectively house thousands of products that come from our supplier base, and we're curating them into these brands providing visual imagery, methods of navigation, and different things that really help the customer shop. So, as a result, because of the nature of how we do it, it actually does not have negative impacts on the way our business operates.

So in other words, we still do not carry inventory. These are items our suppliers are bringing to market that are in line where they're just making distribution choices on who they give them to and who they don't give them to, which incents us further to really drive them in the online channel. And others may have some of these items in their stores or other places, but this really gives us the ability to lean in knowing that their item has some degrees of limited distribution, while we still do not have inventory risk.

Suppliers also, because we're leaning in when these items increasingly gain momentum, they're excited to use CastleGate. So this actually is an accelerant for CastleGate in the sense that CastleGate is meant as a service that really works well when an item has a certain rate of sale. Certain minimum rate of sale or higher. CastleGate is not set up very well to just be a warehouse for speculative goods where someone's going to park a lot of goods there and they may or may not sell because if that's case, they're going to want to just focus on the lowest cost of distribution rather than the lowest cost of distribution for effective, very fast delivery, which is the hybrid intersection that really you think about who could do that. Well, you have to have you own [ph] sortation (54:47), you have to induct into the last mile delivery networks or have your own, you need to have multiple warehouses, you need to have a set of infrastructure that others don't have. And that's why CastleGate does so well.

So to finish up the first point, what I'd say is that the house brands is working incredibly well with regards to building customer loyalty, and it just reinforces the business model that you learned about a long time ago. It doesn't really change it. On the second question, Michael, do you want to comment?

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

Yeah. On the accounting, Mark, though CastleGate is obviously strategically very important and gaining share, the revenue is inconsequential on the P&L. The place it shows up, just to understand the accounting, is it shows up in two places. It shows up a little bit in other revenue and some of it shows up in contra COGS to sort of do the revenue recognition right because obviously we're providing a service to a supplier whose product we're then selling onto the customer. But it has no meaningful impact on the P&L.

Mark A. May
Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks.

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

A

Yeah. Great. And on CastleGate, I'd just say that it's ramping quite nicely. And you can see that because you can see all the facilities we've opened and you can see that the unutilized rent has not really grown, which gives you sort of a feeling for the rate of growth of utilization in the network because it's been ramping at a rate that's been able to absorb the huge expansion of that network, and we're really excited about the footprint we've built out and how we think it's going to continue to ramp.

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

So anyways, everyone, thanks for calling in. We appreciate your interest, and have a good holiday season.

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