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Wayfair, Inc. (W)

Q2 2018 Earnings Call

CORPORATE PARTICIPANTS

Joseph Patrick Wilson
Associate Director of 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

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

John Blackledge
Analyst, Cowen & Co. LLC

Oliver Wintermantel
Analyst, MoffettNathanson LLC

Seth M. Basham
Analyst, Wedbush Securities, Inc.

Akshay Bhatia
Analyst, Bank of America Merrill Lynch

Michael Graham
Analyst, Canaccord Genuity, Inc.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Leandra, and I will be your conference operator today. At this time I would like to welcome everyone to the Wayfair Q2 2018 Earnings Release and Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. [Operator Instructions] .

Thank you. Joe Wilson, Associate Director of Strategic Finance and Investor Relations, you may begin your conference.

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

Good morning, and thank you for joining us. Today we will review our second quarter 2018 results. With me are Niraj Shah, Co-Founder, Chief Executive Officer, and Co-Chairman; Steve Conine, Co-Founder and Co-Chairman; Michael Fleisher, Chief Financial Officer, and Julia Donnelly, Head of Corporate Finance. 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 2018. 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 2017 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 would like to turn the call over to Niraj.

Niraj S. Shah

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

Thanks, Joe, and thank you all for joining us this morning. In Q2 Direct Retail net revenue grew by $538 million or 49% year-over-year and total net revenue grew by 47% year-over-year. Our U.S. and international businesses both exhibited strong growth with U.S. Direct Retail net revenue up $420 million or 43% versus Q2 last year and International Direct Retail revenue up $118 million or 94% versus Q2 last year. This quarter represented the largest year-over-year Direct Retail dollar growth in our company's history which is particularly noteworthy given the tougher comparison in Q2 last year.

We are excited to see the share that we are continuing to gain as consumers increasingly shop online and increasingly choose to make their home purchases with Wayfair. At the end of Q2, our LTM active customer count reached 12.8 million customers and LTM revenue per active customer reached $440, another all-time high.

We view these results as signals that the investments we have been making in our three key strategic areas, namely, one, our proprietary logistics network; two, our International business; and, three, in head count to build out our product category and service offerings are continuing to yield results and put us in a strong position to keep capturing the $600 billion market opportunity we see ahead of us.

Q2 this year was particularly strong as a result of our first ever Way Day event in April. As I mentioned on the last earnings call, Way Day performed extremely well for us resulting in the largest single revenue day in our history. The event resonated strongly with both new and repeat customers and as the remainder of the quarter played out, we are pleased to see that there was no meaningful cannibalization of sales throughout the rest of the quarter. We're excited to develop the event in future years.

Last quarter I updated you on the growth in our International business, and in particular, our expansion in Canada. We remain very excited about the investments we're making in Canada, the United Kingdom, and Germany, and the response we're seeing from customers. This morning I will provide brief updates and examples within our other two main investment areas. First, the steps we're taking to further develop our logistics network and second the investments we are making in head count to improve our product and service offerings within our addressable market.

Each of these initiatives involves work across many different areas, but today I will highlight inbound supply chain services, the outdoor category, and design services as three specific examples of the broader work we are doing. Our proprietary logistics network continues to expand, reducing our reliance on third parties and enabling us over time to increase delivery speed, lower damage and costs, and improve satisfaction for more and more of our customers.

In North America, we are now operating 25 of our own last mile delivery facilities with the recent additions of Nashville and Portland, giving us coverage of 63% of our U.S. large parcel home deliveries and just under 40% of our Canadian large parcel home deliveries.

We're also continuing to take greater control of the middle mile of the delivery process. In June, approximately 90% of our U.S. large parcel orders flowed through the Wayfair controlled middle mile network of consolidation centers, cross docks, and line haul. These improvements across the Wayfair Delivery Network or WDN are enabling us to offer faster and more convenient deliveries for our customers, and our customer net promoter scores for large parcel items reached an all-time high in the first half of this year, which is a great endorsement of the steps we are taking.

Taking greater control of the various stages of our supply chain and logistics is a core part of our strategy. One area where we are particularly focused on adding new services is the inbound supply chain. This is the physical transportation of goods from the manufacturer's factory to our warehouse. This transportation leg can be costly and complex in our category, and we are taking further steps to increasingly coordinate the process on behalf of our suppliers. This increased level of control is beneficial to suppliers, customers, and Wayfair, as we can take costs out of the system, improve in-stock availability, increase fast delivery through smarter geographic positioning, and free up suppliers to focus on their core areas of expertise such as product design, sourcing, and manufacturing.

In 2017, we secured an NVOCC license from the Federal Maritime Commission in the United States, and this year we secured similar licenses from the Ministry of Transport in China and the Canadian Border Services Agency. These licenses enabled us to conduct a pilot in the first half of this year where we directly contracted with shipping companies on behalf of our suppliers in shipping containers of product from Asia to our CastleGate warehouse network in the United States.

Following the positive conclusion of the pilot, we are now offering these ocean freight services to a wider group of CastleGate suppliers in addition to continuing to scale other inbound services such as drayage and freight pickup. We are uniquely positioned to offer these services, as unlike third party logistics providers we're also the recipient of the inbound goods and have a vested interest in ensuring that we position those products as efficiently as possible across our CastleGate network to meet the demand we are seeing from our customers. As a result, we are developing a new supply chain visibility platform that we can offer suppliers bringing in integrated technology-based solution to processes that traditionally intermediaries have coordinated by email or paper communication.

This is a perfect example of what we can do with the power of almost 1,900 engineers and data scientists and a technology platform purpose-built for our business. By equipping suppliers with a simple yet comprehensive level of online trackability of goods in transit, we will enable them to grow even more quickly with us as our business scales.

A further area of potential expansion that we are excited about is moving up the supply chain even further by providing the consolidation of goods in China, Vietnam, and Malaysia. Approximately two-thirds of inbound volume to our U.S. CastleGate warehouses is container direct today, and sending product to CastleGate from Asia the economics of transportation typically make it cost prohibitive for suppliers to send product in containers that are only partially filled. This effectively results in suppliers facing a minimum order quantity when shipping product to CastleGate. By moving closer to the source of supply in Asia, we can receive cargo earlier in the process and fill a single container with products from multiple suppliers enabling suppliers to ship lower quantities of a given product to CastleGate on a cost effective basis.

This consolidation yields the further key benefit of enabling us to have a more diverse range of products in optimal quantities sent to the desired CastleGate facility in North America or Europe at the lowest cost. We are just piloting this strategy at present but we are excited by its future potential.

The second main investment area that I want to turn to now are the steps that we are taking to grow share of wallet by deepening and broadening our value proposition to customers within the home category. Last quarter I highlighted as an example the work that our teams are doing in the bathroom vanities category. This morning I'll tell you about the efforts we are making to capture greater share in the wider outdoor category.

In Q2, the outdoor category has heightened appeal to our customers as they look to refresh their outdoor space with the arrival of spring. Our business model has put us in a strong position to win share across this category. Brick and mortar retailers typically run a much shorter outdoor season in their stores than we can, principally due to their focus on optimizing use of floor space throughout the year. As an online business, we can offer customers a greater range of products over a longer period of the year than they would see in a retail store. Brick and mortar retailers must pick products well in advance of the start of the outdoor season that they predict will be most popular with customers in their short outdoor sales window.

We're able to avoid the risk associated with this due to our business model where we take minimal inventory. Instead, we work closely with suppliers to help them predict demand for their products on Wayfair leveraging the vast customer data and analytics we have to help them become more comfortable preparing for a longer selling season than they would previously have worked to. We also use data to help suppliers quickly react where we see popular trends or runs on specific items to ensure we avoid out of stocks and maximize sales.

Outdoor is a broad category, and as a result is well-suited to the endless aisle of products we can offer to customers. Outdoor furniture such as dining tables and patio seating proved to be an early success for us, and as we have scaled our business, we have seen attractive opportunities to offer customers a wider range of products such as outdoor decor and outdoor structures. Products in outdoor decor and structures can range from lower ticket, lower consideration items such as garden ornaments and bird feeders to higher-priced more considered items such as sheds, gazebos, hot tubs, and saunas. We are enjoying early success in these categories with, for example, over 13,000 gazebos and 7,000 hot tubs sold on our sites over the last 12 months.

And we believe there is considerable opportunity to scale further. To accelerate our growth in these categories, we have been hiring new people to develop dedicated cross-functional teams across areas including merchandising, marketing, and engineering as well as specialized customer service staff. In outdoor structures and spa where products typically retail for thousands of dollars and where technical specifications are often critical to customers, we have invested in rich visual merchandising and product information to give customers the confidence to make informed purchase decisions.

Delivery and installation are also critical parts of the overall customer experience in this category where products like a hot tub or sauna can have specific technical requirements and routinely weigh over 500 pounds. We're continuing to enhance our offering in outdoor decor, structures, and spa as we build out our team, but are very pleased with the early response from customers with these three categories combined having an annual revenue run rate of over $150 million. We have a proven playbook for category expansion, and we are confident in our ability to give customers an experience that will lead the way in these and other categories.

In addition to hiring great people to penetrate product categories like outdoor decor and structures, we're also hiring teams to enhance the services we offer our customers.

For my last topic today, I want to briefly highlight an exciting example of such a service, namely our design services offering which launched last month. We know that one of the top reasons customers leave our site without completing their purchase is that they are not confident in their own ability to pick something that will look fantastic. They struggle with the basic question of is this the right piece, and seek advice or confirmation.

The aim of design services is to help customers achieve their vision for their home by connecting them with a friendly professional interior designer who can fully leverage our selection of over 10 million products to find exactly the right products to suit the customers' style. With experienced and vetted interior designers and easy to use tools, we think there's a huge opportunity to make this process much easier and more fun for customers while also giving talented interior designers access to a steady stream of projects.

For many of our customers, traditional interior design services are considered too expensive, and we have therefore built design packages that are priced to be much more accessible in either $79 or $149 each. Customers will work closely with an interior designer, who has been vetted by us before joining our platform to create a mood board and shopping recommendations and at the $149 price point a floor plan and rendered room view to help the customer visualize the final design in even more detail. Customers and designers will be able to communicate online and by phone with the live interaction being a key part of the value proposition enabling customers to comprehensively articulate their vision and for designers to efficiently build the best possible solution. We're excited to test this offering with customers over Q3 and to further refine our proposition based on the responses we see from customers as uptake grows.

We are taking a large number of steps across our business to bring customers the best possible offering in our category online, and we're thrilled with the response that we are seeing. We believe that the growth opportunity that lies ahead is considerable and that we are ideally placed to keep winning with customers.

Now I'll turn the call over to Steve to talk about our approach to customer service and sales.

Steven K. Conine

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

Thanks, Niraj. On previous earnings calls we've spoken about centrality of technology in bringing our customers the best possible experience when shopping for the home from the home. Today I want to tell you more about the critical role that customer service plays in that experience. The home category has specific challenges when shopped online and giving customers the confidence to buy in absence of being able to touch and feel a product is often problematic. At Wayfair, we leverage technology such as Search with Photo, View in Room 3D, and Day of Delivery Tracking to make it as easy as possible for customers to shop our category online.

We believe that alongside technology, our award winning customer service team plays a key role in bringing customers the end to end support that differentiates us in the market. The ability to speak with a member of our customer service team, whether it's on the installation of a chandelier or the delivery of a bunk bed can often be a key part of the customer's experience with us. We combine both technology and customer service to achieve this in a way that has been central to our success as a business.

When Niraj and I started this business, we would answer customer calls and new hires would do this when they joined the company. This has remained a core part of our DNA with all the new hires joining Wayfair in Boston today still listening to real customer calls on their first day with the company. Technology is central to our business and to our competitive advantage, but staying as close as possible to the customer is the driver of our success and our culture.

We have built a team of over 2,300 customer service and sales staff across seven locations in the U.S. and two in Europe. All of the team are Wayfair employees rather than outsourced, enabling us to build a depth of expertise in the team and a true sense of caring for the customer that is key in our category. We give customer service agents the autonomy to handle complex issues and do what is best for the customer, avoiding the scripts and red tape that often get in the way of delivering the best results in a timely manner. This customer centric approach resonates strongly with our team as seen through our recent employee engagement survey with 93% of our sales and service employees feeling empowered to solve customer problems.

We have invested in building support teams across the customer journey from pre-sale support through day of delivery. As our business has grown, we have scaled the number of people in our sales team with specialized product knowledge to ensure that we can provide the product expertise that our shoppers require. Matching a shopper who is exploring a more complex product category with a product specialist with deep knowledge of this space enables us to equip customers with the confidence that is integral to making an informed purchase decision.

Our data science enabled routing technology ensures that when these customers call us, they are connected instantly to experts in the category they're shopping for, avoiding the frustrating phone menu selections to fight through before they are connected to a live person. Phone orders with complex issues that can't be resolved on the first contact or through our extensive self-service options, we provide customers with a dedicated service consultant to handle their order issues until the problem is fully resolved.

Our proprietary technology and analytics provide our team members with extensive data insights on customer orders and allow them to intervene proactively when issues surface such as delays in transits or back ordered items. Our testing has shown this proactive outreach can raise customer NPS significantly compared to situations in which issues are not managed proactively for customers.

Finally, delivery is often a source of anxiety for customers and an area that we believe has been overlooked historically in our category as other players have not had the national scale or customer focus necessary to build the best possible delivery experience. In the geographies where we have established our own last mile delivery agents, customers can use Day of Delivery Tracking on their mobile device to track the expected arrival of their items.

Additionally, in each of these locations, there is a home delivery consultant that customers can speak with live to find out more about their delivery and resolve any issues they may have. Coupling leading technology with the ability to speak with informed and empowered members of our customer service team puts us in an ideal position to bring customers a great experience throughout.

I'll now turn the call over to Michael to discuss our Q2 financials in more detail.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

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

In Q2, our Direct Retail business increased 49% year-over-year to $1.641 billion representing year-over-year dollar growth of approximately $540 million. Our total net revenue increased 47% year-over-year to $1.655 billion. We are delighted with the dollar growth in revenue that we are seeing.

As Niraj mentioned earlier, Way Day added further strength to our Q2 results and we're excited to develop this event further for customers and suppliers next year. Our KPIs which we report on a consolidated global basis showcase the extremely strong response we're seeing from our customers with many KPIs reaching all-time highs.

In addition to our active customer base growing by 34% year-over-year in Q2, purchase frequency as measured by LTM orders per active customer grew for the seventh consecutive quarter to a new high of 1.82 and orders from repeat customers grew by over 60% in Q2 year-over-year.

Turning now to our U.S. business, Direct Retail net revenue increased to $1.397 billion in Q2, up 43% year-over-year representing year-over-year dollar growth in the quarter of approximately $420 million. Direct Retail net revenue from our International businesses in Canada, the UK, and Germany collectively increased to $244 million, up $118 million versus Q2 last year.

Our offer is resonating with customers in International markets and we're very pleased with the market share we're taking as a result of our long-term investments outside the U.S. I'll share the remaining financials on a non-GAAP basis excluding the impact of equity-based compensation and related taxes which totaled $32 million in Q2 2018.

For a reconciliation of GAAP to non-GAAP reporting, please refer to our earnings release on the IR site. Our gross profit for the quarter which is net of all product costs, delivery, and fulfillment expenses was $386 million or 23.3% of net revenue, consistent with our near-term expectations for gross margins in the 23% to 24% range. We're continuing to see attractive opportunities to invest ad dollars behind the healthy conversion and repeat rates our customers are demonstrating.

Q2 advertising spend of $178 million or 10.7% of net revenue represents year-over-year leverage of over 30 basis points as we invest in engaging both new and repeat customers and benefit from a growing base of repeat customers who require a lower level of ad spend per dollar of revenue. As a reminder, the year-over-year leverage we delivered is despite the negative mix shift impact from our International business, which runs at a higher ad spend as a percentage of revenue due to its lower base of repeat customers and continues to outpace the revenue growth of the U.S. business and take share.

Looking out to Q3, we're comfortable leaning in on ad spend while maintaining our overall one-year contribution margin payback target given the ongoing strength we're seeing in our customer KPIs. We therefore expect overall ad spend as a percentage of net revenue to increase sequentially in Q3 versus Q2 as it did last year, while still showing a modest amount of year-over-year leverage compared to the 11.8% level of Q3 last year.

Our non-GAAP selling, operations, technology and G&A expenses are driven primarily by compensation costs, and in Q2 totaled $211 million. As I highlighted in detail on our last earnings call, we are continuing our ramped up hiring across the business as we invest further based on the results we are seeing in our three main investment areas of building out our International capabilities, developing our proprietary logistics network, and increasing our penetration of categories and services where we have historically under-indexed.

Our KPIs have strengthened further in the first half of 2018, and we feel extremely bullish about how the customer is responding to the investments we're making. Hiring truly great people is central to this long-term approach to growth, and we are taking a high conviction approach to building talent across our business. In the second quarter, we added 960 net new employees for a total of 9,713 employees as of June 30, 2018.

Approximately 650 of the net new employees in Q2 were in OpEx areas such as marketing, merchandising, operations, and technology. Similar to the numbers we added in Q1. Our employer brand is showing great strength as awareness of our business and the careers we offer has grown. In the first half of this year, we added over 1,300 net new employees in these areas compared with less than 900 in the whole of 2017. And following the considerable success of our campus recruiting activities this year, we expect that Q3 net adds in these areas will remain at the elevated levels seen in Q1 and Q2 of this year. The incredible success of our recent hiring has allowed us to secure topnotch talent at a faster pace than we imagined at the beginning of the year.

As a result of this higher than expected level of hiring in the first three quarters of the year, we expect that many of our initiatives will be appropriately staffed and we therefore anticipate a sizable sequential step down in hiring in Q4. We think this step down will be to a new, more normalized growth level which will then lead to sequential OpEx leverage showing up in the financials as we move through 2019.

These new hires take time to onboard and ramp up, and many of them are focused on medium and longer term initiatives within our three main investment areas that will not contribute meaningfully to revenue right away. This accelerated head count growth will therefore weigh on our near-term profitability, but we believe they are the right investments to make given the scale of the opportunity we see ahead of us, the success we have seen to date with the prior investments we've made, and the positive reaction we are seeing from our customers.

Across our strategic priorities, we have always invested in a way that best serves our customers over the long-term, and we do not attempt to match spending in a particular quarter with revenue in that quarter. This approach has served us incredibly well historically, and we would not be adding to our employee base at these levels if we weren't incredibly bullish about their ability to help us continue capturing share of the approximately $600 billion total addressable market we see ahead of us.

Turning to our logistics investment, the build-out of our CastleGate and WDN facilities in the U.S. and internationally puts us in a strong position for continued growth, but it does mean that unutilized rent continues to weigh on our P&L in the $5 million to $8 million range per quarter in OpEx.

Adjusted EBITDA for Q2 2018 was negative $35 million or negative 2.1% of net revenue. Adjusted EBITDA for the U.S. business in Q2 was $7 million and adjusted EBITDA for the International business was negative $42 million as we continue to invest in our three international countries. Non-GAAP free cash flow for the quarter was negative $8 million based on net cash from operating activities of $48 million and capital expenditures of $56 million. CapEx spending was 3.3% of net revenue for Q2.

For Q3 we expect CapEx to be 3% to 4% of net revenue. As of June 30, 2018, we had approximately $585 million of cash, cash equivalents, and short and long-term investments.

Before I turn to guidance for the third quarter, I want to briefly revisit our second quarter performance to provide some additional context. As Niraj mentioned earlier, at approximately $540 million of year-over-year growth the second quarter represented the largest year-over-year Direct Retail dollar growth in our company's history despite a stronger comp in Q2 of last year. Part of this outstanding result was driven by our first ever Way Day event in the U.S. and Canada in April which resulted in the largest single revenue day in our history. For Q3 quarter to date, our growth in Direct Retail gross revenue is back to running at a more normalized level of approximately 40%.

Setting guidance is always a difficult task given our rate of growth and predicting the exact timing of the payoff through various initiatives adds an additional layer of complexity. The guidance we're giving for Q3 reflects that and our desire to be prudent when forecasting our mass market consumer business where the customer has to show up every day.

For Q3 2018, we forecast Direct Retail net revenue of $1.61 billion to $1.645 billion, a growth rate of approximately 36% to 39% year-over-year, and representing year-over-year Direct Retail dollar growth of approximately $450 million.

Within that, we expect U.S. Direct Retail year-over-year growth in the range of 34% to 36%, and International Direct Retail year-over-year growth in the range of 50% to 60%. We forecast other revenue to be between $13 million to $17 million for total net revenue of $1.623 billion to $1.662 billion for the third quarter.

For consolidated adjusted EBITDA, we forecast margins of negative 3.7% to negative 4% for Q3 2018. We expect International adjusted EBITDA to be negative $45 million to negative $50 million in Q3 as we continue to add resources and ad spend in Canada, the UK, and Germany. In the U.S. business, we expect to deliver adjusted EBITDA margin of approximately negative 1% as we invest primarily in head count to build continued scale in our primary market. As I highlighted earlier, we expect the rate of hiring to continue at elevated levels in Q3, and this will weigh on Q3 profitability before an expected sequential reduction in the rate of hiring in Q4, as we both slow the pace of hiring substantially and start to see the leverage of the larger employee base spaced off on our many growth initiatives.

We remain incredibly bullish about our business both in the near-term and long-term. The investments we have been making to bring our customers the best possible offering are clearly working, with strength across our customer KPIs and our market share growing as a result. We plan to continue investing in these strategic priorities and are excited by the scale of the opportunity that we see in front of us and our ability to keep winning as we go after it.

For modeling purposes for Q3 2018, please assume equity-based compensation and related tax expense of approximately $36 million to $38 million, average weighted shares outstanding of 89.8 million, and depreciation and amortization of approximately $32 million to $34 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 very excited about the growth of our business this year and the position that we have put ourselves in to take advantage of the opportunity we see ahead of us both in the U.S. and Internationally. We are extremely proud of our growing team of almost 10,000 people and the initiatives they are driving to bring customers a terrific experience when shopping for the home online.

Dollars in the home category are continuing to move online, and we believe we can keep taking an outsized 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] . And your first question comes from the line of Peter Keith with Piper Jaffray. Your line is open.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Hi. Thanks. Good morning. Congrats on another good quarter. I want to just ask a bigger picture question around free cash flow. I know that you guys have historically guided the business that you want to achieve positive free cash flow on an annualized basis and clearly you've made some very successful logistics investments but you're looking at probably your third year in a row of negative free cash flow. Just thinking forward as you're building out China, do you feel like you're now sort of past that CapEx ramp such that's free cash flow – positive free cash flow will begin to flow, or do you feel like the logistics are still building and getting good returns, and so it will push that free cash flow target out further?

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

A

Hey, Peter, this is Michael. Let me start and maybe Niraj may want to add. I think that you've seen the – the CapEx growth, it sort of accelerated for a while. I think now we're at that running solidly 3%ish of revenue, and I think we guided again this quarter to run at that. There's clearly a set of ongoing CapEx investments we're making as we continue to expand and build out the logistics network. But, remember, we went through this period where we like had this intense build it first instance, right, get the first thing built, and went from zero no CapEx to building it. I think, we're through that phase. Now we're adding onto it and obviously the scale of the business has grown dramatically during that timeframe, so the CapEx dollars even though they have grown some versus the overall scale of the business and what the business can generate are quite different. I do think we're still on a path over time to free cash flow breakeven and then positive. That's still the goal. But as you can see in this quarter and our guide for next quarter and the things we're trying to invest in, we're going to always balance that with making the right long-term investments for the business.

I don't know if Niraj wants to comment on China and some of the other rollouts.

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

A

I guess, the thing I would comment on, China, what we would do in China is not going to be particularly CapEx intensive. The operations that are more CapEx intensive tend to be ones that have more automated sortation, things like that. Those tend to be integrated then with the transportation, whereas in China you have warehousing, but you're effectively building full containers, you're doing break bulk of truckload and that's more manual.

What I would say is, the other thing to think about is, I wouldn't think about free cash flow as being entirely a function of kind of CapEx type of fulfillment. Also just keep in mind when you think about rate of growth you think of the 20% variable contribution margin, you think about flow through into EBITDA. We believe we can grow at a significant rate on an ongoing basis, and so if you look at our dollar growth, you see that continuing to build. And while in this recent period we've ramped head count, Michael made some comments also about head count how it's going to moderate the hiring as we get to the end of this year. So what you'll see is you'll see leverage on that line and flow through into EBITDA. That will also create cash flow as you roll forward.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay. Very good. And just maybe closing out on the logistics, could you just give us a quick update on some of the metrics in terms of like how many millions of square feet you now have with CastleGate and with WDN I think you said 25 facilities, can you remind us where you are targeted by year-end?

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

A

Yeah, the square footage number hasn't changed dramatically this quarter because we didn't open any big boxes. And we continue to add the smaller footprint DAs. So I think the last number – I'm just trying to find the last number, we gave was 8 million square feet in total or something like that, and that number is still good.

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

A

In terms of the delivery agents, the DAs, the 25 number, we're continuing to expand markets. I ballpark think of it as one to two a month as average. We mentioned this quarter we had two that rolled out this quarter, so it's not exactly one to two every month, but we continue to roll those out. Remember, those are fairly small buildings, and we've done most of the major markets. So we're kind of on the secondary markets. But when we do get to roll them out, it's a significant benefit because of the jump in net promoter score and we have the density to either you look at the unit cost or the delivery, we have the density to make that work. So we're going to continue to roll those out.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay. Very good. Thanks very much.

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

John Blackledge
Analyst, Cowen & Co. LLC

Q

Great. Thanks. A couple questions on the guide and then a question on the logistics. So on the guide, the modestly negative U.S. EBITDA in 3Q being driven by higher head count, Michael, could you just discuss the accelerated head count growth, what areas again? And then the International revenue guide, I think I heard plus 50% to plus 60%. Is the decel from kind of 2Q, 1Q levels? Just kind of any color there, Way Day impact kind of skewing the growth rate for International in 3Q? And then for Niraj on the discussion on inbound supply chain investments, how long will it take to ramp this program, and are you aware of any competitors that are kind of taking this approach? Thank you.

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

A

Great. I'll start. On the guide and the head count growth, as we talked about, you can refer back to last quarter's call because we kind of went in-depth there and decided not to do it again this time. But we are really hiring across all areas of the business. Obviously there are sort of key critical areas like engineering where we've had really good growth in that team and we'll continue to do that. And the thing I'd point out is that we had a – we've really been able to sort of find the type of talent and we've built the recruiting team to sort of find the type of talent we want in a faster way than I think we anticipated at the very beginning of the year. And so though it's accelerated and I'm using those words, it's – what we're really doing is we've been able to do what we were trying to do over four quarters in really three quarters.

And so we'll continue to hire a substantial number of people in Q4, but it will be a lower number than it was in Q1, Q2, and now Q3. And I think in part, that's because people across the spectrum of the folks we're looking for, right, great operations people, great merchandise people, great marketing folks, great engineering folks, the talent that we have been able to add to the team when you start to look at the profiles and backgrounds of these folks has been stellar. The other side of it is we built out a substantial campus recruiting program and the quality of people we're getting out of topnotch MBA programs and places like that has also exceeded our expectations.

And so, I think, it's across all areas of the business, and as we talk about places we're investing, Niraj spoke about some of the outdoor categories, and we're talking about the logistics rolled out. Each one of those has a team of people, a cross-functional team that touches all of these disciplines faced off against sort of building that. So you think about design services and what that team looks like in terms of the marketing folks, the engineering folks, the product folks, the operations folks to go execute on that at scale with our customers. That's really what we're – those people are coming on board to do.

To answer the question on International growth, I think a couple thoughts there. One is we did run the Way Day program in Canada, so that was a positive spike to the Canadian business like it was for the U.S. business in Q2. And so there's a little bit of that impact. And then the other thing is remember the International businesses are three separate businesses. There are very different points in their life cycle, and some of them, Canada being a good example, are starting to get to sort of a meaningful scale at which – where their growth rates even though their dollar growth will be – remain quite high, their growth rates will be a little lower. I think if you look at the dollar growth of the guide compared to what the International business did in Q1 or Q4, you'll see that the dollar growth is sort of remaining strong in what we're guiding.

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

This is Niraj, just to [indiscernible] (44:39) – on International, I think, yeah, if you look we were kind of in the $90 million range sort of popped up here with the Way Day in Canada, but we're going to see continued solid growth there, we believe. In terms of the inbound supply chain services, I think what we're seeing is competitors in general have not invested into logistics in the same way that we believe one frankly should and would benefit from. Obviously Amazon is a notable retailer, who has invested in logistics, but if you hold them aside, you really don't see that out there. And we think, it's one major source of benefit particularly when you think about the goods we sell because they're relatively bulky, they tend to be low dollar value per cubic foot, we have a subset of goods that are prone to damage, and these attributes make logistics even more valuable particularly in a world where two day goes to next day, and goes to same day. So we think we have an advantage there, and we think if you think about it as a platform there's a lot of benefit we can offer to not just our customers, but our suppliers by providing these services. So that's why we continue to be aggressive in building them out.

John Blackledge Q
Analyst, Cowen & Co. LLC

Thank you.

Operator: Your next question comes from the line of Oliver Wintermantel with MoffettNathanson. Your line is open.

Oliver Wintermantel
Analyst, MoffettNathanson LLC

Q

Yeah, good morning, guys.

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

A

Hey, Olly.

Oliver Wintermantel
Analyst, MoffettNathanson LLC

Q

I had a question regarding tariffs and the impact on Wayfair. If you maybe could remind us what your imports are from China and off of these inputs what are direct imports and how much is the indirect imports?

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

A

Sure, Olly. Yes, so I think the thing to keep in mind is tariffs are going to affect us a lot less than they will virtually every other retailer. And the reason is when you think of us as a platform, we effectively desire to sell every item from every supplier in the market. And so we have goods on our platforms that are manufactured in Asia, we have goods on our platform manufactured in the United States. Certain industries are all in Asia, certain industries are all in United States, certain industries are different suppliers, sourced different ways. So we have all of those goods.

I think our actual mix, I don't have the exact number, obviously a significant amount come out of Asia, which is China, but also Vietnam and Indonesia. And what you find is that if you look at kind of the global amounts by category and you break it out, our sales – we've actually looked at this – not terribly different than that. And the reason we get hurt less than other retailers, other retailers made concerted decisions, so if they sourced specific outdoor furniture, and they decided to source it from one supplier in China versus one supplier in Indonesia and then there is a tariff. Well, if they were sourcing from China, they then bear the cost of the tariff, whereas we're sourcing from both those folks and we're not buying any inventory. It's the supplier's inventory.

So, if some suppliers get advantage relative to other suppliers, frankly they'll do better or worse if they get advantage or disadvantage on our platform because the consumer will decide where they want to shop in terms of whose item they want to buy. And so we saw this with Brexit.

When things happen, when there's abrupt shocks it does create demand kind of changes, but because the nature of our platform two different things happen. One is basically we're not that affected, suppliers then tend to rebalance what they do over time. The second is I actually think these things have less of an impact because ultimately it affects the whole market, and so it's basically just an inflationary sort of driver to the consumer which then gets absorbed. But frankly we tend to be able to ride these things out better.

Oliver Wintermantel
Analyst, MoffettNathanson LLC

Q

Got it. Thanks. That's helpful. And just one follow-up to Way Day if my math is correct, the repeat order is up 62% in the quarter and the new customer growth is up 33%. So the repeat order is up quite a lot, but the new customer growth – order growth is – stays relatively flat. So is it fair to assume that Way Day was more – did you see more repeat customers of your repeat customers come back and buy Way Day or is that not the case?

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

A

Yeah, I wouldn't really look at it that way. We found Way Day to be very successful for both, I mean, if you look at our share of orders that are repeat, it ticked up from a year ago at 61%, you get to 62%, a quarter ago 64%, now where 66% of our orders are repeat. So repeat has been an ever-growing flywheel, quarter ago repeat was up just over 50% year-over-year, this quarter it was up 60%. New customers this last quarter was up by 25%. This quarter it was up 33%.

So we just have really good momentum on both fronts. Way Day, we saw specifically good momentum on both fronts. And repeat continues to take shares as a portion of the total simply because once we get a customer, the experience is very delightful to the degree that they start shifting more and more of their spending to us. But we're continuing to get more and more new customers at a strong pace, and you saw our active customer count now up to 12.8 million [indiscernible] (49:32) the back of that. So both numbers are actually quite strong, if you look at the trends on them.

Oliver Wintermantel
Analyst, MoffettNathanson LLC

Q

Got it. Thanks very much.

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

A

Thanks, Olly.

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

Good morning.

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

A

Good morning.

Seth M. Basham
Analyst, Wedbush Securities, Inc.

Q

My question is around your logistics investments. You talked about higher net promoter scores from your Wayfair Delivery Network. Had those net promoter scores been translating into higher repeat order rates and higher revenues?

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

Thanks, Seth. The short answer is we think so. The long answer is it's – you have – you need a long period of time to try to measure that, and it's very hard to isolate that because there's so many other things we continue to improve on in that same period. When we've done lookbacks and what we found is that net promoter score is correlated to lifetime value and repeat growth. So we use net promoter score as sort of a near-time measure of that, and we use kind of three and seven, 14-day repeat rates as indicators of long-term rates, then we do lookbacks to make sure they stay very correlated. I can't specifically tell you for the large parcel home delivery operation, and its increasing net promoter score what is specifically driven because you can't isolate that separately with enough data. But I would believe the answer is yes.

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

Fair enough. And secondly as it relates to logistics, from a gross margin standpoint, when would you expect less pressure from the logistics investments and from the operating margin standpoint when should we see less a burden of the unutilized rent if you're not opening new CastleGate warehouses and sales keep rising, I would expect that burden to come down, but you've signaled that it's remaining in the $5 million to $8 million range. Thank you.

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

Yeah. So what we've said for a while now is that we're – there's a little bit of a drag from the addition of the logistics network, and that's showing up in COGS, and you'll see that when the Q comes out and the details in that like last quarter continued this quarter. And that will over the course of the coming quarters and we haven't sort of put a pin in sort of exactly when, but I think over the course of the coming quarters you'll start to see some of the benefits of that flow through. In other words you'll start to see some of the efficiency gains in the COGS line particularly in the shipping part of the COGS line as we kind of operate a lot of that network at more peak or full efficiency.

On the unutilized rent piece, we are continuing to add CastleGate network buildings, so Toronto was the most recent one, and then there is others that are sort of going to flow in over the next several quarters. And so – and when that happens, you effectively sort of rebalance the whole network of those CastleGate facilities. But I think as we continue to grow, the growth of CastleGate capacity will be tied to sort of the growth of the business. But we will for some period of time have an ongoing unutilized rent piece as we're never going to let the network right now get to a place where you're operating it at 100% able to flow all of that rent through COGS because you got to be anticipating at our rate of growth, you got to be anticipatory and make sure that you've got enough facility space ready as the business grows and as you keep hit peak demands like holiday.

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

One other comment quickly on gross margin too. Just keep in mind the movements you see in gross margin I wouldn't directly correlate those to being driven by logistics. At a high level some puts and takes on gross margin, when you follow it from quarter to quarter. For example, a positive thing that happens to gross margin would be due to shipping savings, but a negative thing could be when we're ramping a new logistics facility could be a drag.

But then the category mix is a drag so we have a lot of new categories ramping nicely which start at lower gross margin, the International mix where International is growing faster is a drag because International does not run at the same gross margin as the U.S. yet and that's typically a function of scale.

But then the buying power, as we get bigger that's a benefit to gross margin. We get better and better wholesale pricing, and then private label which has grown very nicely for us is a benefit. So when you net all those in and you see gross margin sort of not move that much stay in that 23% to 24% range, you're actually seeing a lot of positive things there that are helping us absorb the fact that International and category mix which are both huge future drivers of benefits for us, they're not actually providing a negative drag because of the benefits we're getting elsewhere. So you've got to kind of net them all in and obviously the unutilized new logistics facilities are another investment area, and that's getting absorbed also. So we have a lot of positive things in there too.

Seth M. Basham
Analyst, Wedbush Securities, Inc.

Q

Great. Thank you very much.

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

A

Thanks, Seth.

Operator: Your next question comes from the line of Akshay Bhatia with Bank of America Merrill Lynch. Your line is open.

Akshay Bhatia
Analyst, Bank of America Merrill Lynch

Q

Hi. Thank you. One theme that is becoming more prevalent in the e-commerce space is advertising within the marketplace. So I wanted to ask you what Wayfair is doing on the advertising front, maybe what opportunity you see there, and what tailwind do you think this could be to margins longer term?

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

A

Yeah, we think advertising is an area of very high potential benefit. To be fair on one hand we think we're very excited about it. We talk about hiring people [ph] for each (54:52) teams and the investment we're making in head count. This is a great example of an area that over the last couple quarters we've really staffed that up with a great team that I'm very excited about a lot of the early work they're doing. But then to be fair, it's early work. So in terms of when it's a real impact on the P&L, it's still a little ways out.

For us we think advertising is going to be a little more nuanced that what some other folks can do, where they can just kind of plaster it on the top because that doesn't affect the customer experience negatively, because for example if you're selling batteries, whether you like Duracell or Energizer dominate the page doesn't matter as long as you have both on page one and page two. We need to be thoughtful in terms of making sure that we use a diversity of product, the right styles for the consumer to continue to engage them, but then there's things we can do for example to let suppliers help launch their new products and get them ramped more quickly and help fund that. So we're actually very excited about some advertising products that we have underway, but in terms of the P&L impact I would both say I'm excited about how big it can be, but I would also say that that's a ways out.

Akshay Bhatia
Analyst, Bank of America Merrill Lynch

Q

Got it. And maybe as a follow-up, can you talk about what you're doing differently on the marketing side that you can still drive leverage while adding nearly a million customers? Anything to call out there or is it really just the repeat rate growing?

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

A

I think the key thing to keep in mind on what we do on our paid advertising, and this is a very unique thing for us when you compare us to other folks is we've built all our advertising technology in house.

And so when you think about building your own ad tech, being able to then take your first party data and really nuanced quick stream data, your own algorithms that are honed to your categories and your customer lifecycle and then you take those and integrate them into the advertising products out there, that's a huge benefit. We then kind of further fuel that, Pinterest, Facebook, Google, have all publicly named us as a partner, who they – whom they codevelop ad units, who is their early alpha and beta partner in things. Google mentioned us with PLAs and trusted stores, Facebook mentioned us on their earnings call about a year ago. And so what we find is that by being an innovator and understanding the nuances of how these platforms work and the new products, and then building our own ad tech for integration, for bidding and for our own algorithms that you can always further progress what you can do, and obviously we have a tremendous amount of data that we use.

So there's no reason why if you think about when we think about 12.8 million customers, that's less than 10% of the potential customers. When you think about 70 million households in the United States, 70 million households in Europe and Canada, 140 million, 12.8 million is still not that many. So there's a lot of new customers to get. And then obviously the share of wallet is a huge opportunity, so to your point repeat is obviously a big opportunity too. So I think, building our own ad tech has been a huge advantage, but there's also a lot more customers to get so that's why we can keep adding them.

Akshay Bhatia
Analyst, Bank of America Merrill Lynch

Q

Great. Thank you.

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

Michael Graham
Analyst, Canaccord Genuity, Inc.

Q

Thank you. Just on the customer growth, you added nearly a million customers. Any high level thoughts on the split between domestic and International? Like, are you still seeing really robust U.S. customer growth? And then you had made a comment in the past about margins in a country can be the lowest when you really start to lean in on the brand advertising spend. Can you just refresh us on where you are in that cycle in terms of leverage or deleverage from ad spend in some of your different countries?

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

A

Yeah, so we're seeing really good customer growth in the U.S. and in International. So we're very excited about that. In terms of where we are in the International markets, we've said that Canada is the farthest along and there we have really nice awareness, not quite at the U.S. level, but quite high. UK is ramping very nicely, and then in Germany we're in the early days there. So we just, for example, television advertising, we really launched that in the last month or two. So each country is in a different stage of the evolution. Germany is I'd say at the beginning of really starting to grow the customer base. UK has a nice customer base still in the rapidly growing stage, but it's far enough along. You have a growing repeat base albeit not that far along. I think, Canada is farther along. But all are still very much in that ramp phase which is why when you look at the kind of aggregate P&L impact and you see the losses, that's because it doesn't – in aggregate, we still don't have enough of a repeat base to get that amortization. But it's ramping there. It's headed there nicely.

Michael Graham
Analyst, Canaccord Genuity, Inc.

Q

Okay. Thanks a lot.

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

A

Thanks, Mike.

Operator: Your final question comes from the line of Brian Nagel with Oppenheimer. Your line is open.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Hi. Good morning.

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

A

Hey, Brian.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Nice quarter. And thanks for all the color as usual. So couple just near term modeling questions if I may. First off, we talked a bit about gross margins already, but here in the quarter we saw somewhat of a bounce back than we saw in the prior quarter. Obviously still within your longer term targets. But given what you were saying, I guess, in response to a question before, is it fair to assume that we should see the gross margin rate continue to tick a bit higher through the second half of this year? And then my second question obviously a lot of conversation around [indiscernible] (1:00:11) and the plans to maybe pull back on that a bit in the fourth quarter. Can you help us understand better? Like, I understand you don't give fourth quarter guidance, you haven't given fourth quarter guidance, I mean, how big could that delta within the P&L could that be? And going – looking beyond 2018, like how long do you think this may be a more subdued rate of hiring? How long should that persist? Thank you.

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

A

Sure. This is Niraj. Let me kind of quickly answer both questions, and then Michael can provide more color. On gross margin, here's the way to think about it. What I referenced earlier, there's a lots of puts and takes. And so in any given quarter in the near term, as International grows really fast, well, that's a drag. So new categories we're investing in and seeing great results, that's a drag. But then as you mentioned there's a lot of positive things for gross margin too. So I wouldn't necessarily say in the second half you should see it grow. I wouldn't say in the second half you should see it drop. That 23% 24% is a range where you net in all these puts and takes. If you take the longer term view and you say a number of years out would I expect that gross margin could rise nicely between now and the number of years out, I'd say yes, because fundamentally the long term trends – the positives of the long-term trends are very significant, and in fact the things that are drags become less of drags and they actually kind of erode being a drag over that timeframe. So the long-term view on gross margin is significantly positive. But in the near term, you have a lot of movement there. And then on hiring, I'll let Michael get into specifics. I just want to clarify.

So we're going to continue to be hiring. It's just the recent rate has jumped up significantly and we've built an incredible recruiting capacity so we've taken advantage of that and that right now also includes summer hires and business school recruiting all this kind of coming on board. We don't want to not take advantage of that. So we've taken advantage of that. That said, we're going to drop the net increase rate down, but it's still going to be a net increase continued growth. But from a financial model standpoint, you actually will start seeing sequentially nice leverage once we absorb sort of the hiring which takes a little while to roll through, but Michael can be more specific.

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

Yeah. I mean, the only thing I would add to that is I want to be clear that we're not saying we're not going to still hire a lot of folks in Q4. We are. Just not at the pace we've been hiring in Q1, Q2, Q3. So I think you will continue to see sequential increases in the Op expense – OpEx expense tied to that hiring. I just think that's going to start to ameliorate over the coming quarters. Remember, though, that right the folks you hired in Q2 show up in Q3 comp and Q4 comp, right, it continues to sort of build. And then the only other thing I always note for folks is to remember that in Q1, you sort of reset on all of your tax – the tax payroll, payroll taxes, and therefore that tends to sort of impact our OpEx spending as well there. But as I said on the – in the talk track and as we've now sort of given a little more color on, we will bring that rate down. I think that will be a more sustained long-term rate. We are going to continue to add great people. The business is growing obviously at an incredible pace. And you – but at the same time, you'll start to see leverage over the course of 2019 in that line as we don't keep hiring at this accelerated pace.

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

Thank you.

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

Great. Thanks, Brian. Thanks everyone for being on the call with us today.

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

Thanks, guys.

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