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Wayfair, Inc. (W)

Q3 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Michelle, and I will be your conference operator today. At this time, I would like to welcome everyone to the Wayfair Q3 Earnings 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]

I would now like to turn the call over to Mr. Joe Wilson. Please go ahead.

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 third 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 fourth 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 publically update or revise these statements whether as a result of any new information, future events or otherwise.

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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 Q3, Direct Retail net revenue grew by $511 million or 43% year-over-year and total net revenue grew by 42% year-over-year. U.S. Direct Retail net revenue was up $426 million or 41% versus Q3 last year, and International Direct net revenue was up $85 million or 58% versus Q3 last year. These strong results in Q3 follow the $538 million of Direct Retail net revenue we added year-over-year in Q2, which included our first Way Day representing over $1 billion of Direct Retail net revenue growth year-over-year in the last two quarters alone.

We are delighted to see our offering engage more and more people with 13.9 million shoppers buying from us over the last year and LTM net revenue per active customer continuing to grow, reaching an all-time high this quarter of $443. We've built a customer proposition that is demonstrating increasing resonance with shoppers as you can see in our KPIs, and we feel incredibly bullish about future growth as a result. In Q3, when we saw attractive opportunities to lean in on ad spend while staying within our 12-month contribution margin payback threshold, we did that, as we believe it will augment our long-term growth.

We also continued to benefit from the growing strength of our employer brand, which we highlighted last quarter and we capitalized on that by adding more great people across our business than we expected. By taking a long-term view in building our business, we are able to make near-term tactical and strategic decisions that will put us in the best possible position to keep winning with customers as dollars in our category shift online. From time to time, those steps may result in reduced EBITDA flow-through in a given quarter. By putting those dollars to work in a rigorous and high conviction way, we are taking steps today that will drive growth and profitability for many years ahead.

Across our three investment areas, namely our proprietary logistics network, our International business, and in head count to build out our product category and service offerings, we are very pleased with how we are progressing through our investment cycle. In the early stages of our investment across these areas, there was typically a high level of risk but a low level of investment outlay as we tested the initial concepts. Now, as we're seeing consistently strong results across these areas, such as CastleGate penetration, attractive customer conversion and repeat rates in Germany and several emerging product categories now having revenue run rates over $100 million, we're putting considerably greater sums of money to work to really scale all of those successes.

For example, as I'll talk about later, Germany is currently running at elevated losses as we are in an inflection point in the development of our business there. In Germany, we've built dedicated teams of category managers, we're operating a CastleGate warehouse, and we recently started investing in television advertising spend. These are steps we would only take once we had robust proof points from suppliers and customers that our business was gaining deep traction there. With the scale of our customer base in the U.S., we are now deepening our service offering to win further share of wallet with the launch of offerings such as Design Services which I mentioned last quarter where we have added a couple of dozen people cross-functionally over the last year.

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Right across our business, we're investing heavily at present as we feel more confident than ever that we can continue to lead the way in our category online. The success of our business in the early stage of our investment cycle is precisely why today we are investing so heavily through the middle of that cycle to position ourselves for the scale and profitability that we believe lies ahead. Today, I want to provide brief updates on two of our investment areas, namely our International business and the build-out of our product categories and service offerings to increase our share of wallet.

Our International business in Canada, the UK and Germany generated Direct Retail net revenue of $232 million in Q3, and this quarter will exceed a $1 billion annual run rate in Direct Retail net revenue. To put that growth in perspective, for all of 2016, we had International Direct Retail net revenue of $265 million. We're extremely happy with the momentum we have built since we started to really invest in the UK business three years ago and more recently as we've done the same in Germany.

Canada has grown quickly since early 2016 when we launched Wayfair.ca, enabling us to tailor our proposition much more effectively to Canadian customers, leaning in on ad spend as a result and a year later, we introduced a French language site, which further localized our offering. As I've mentioned on prior calls, our Canadian business benefited substantially from leveraging the U.S. catalog and logistics infrastructure and as a result is our largest single international region today, accounting for approximately 60% of International revenue.

Our aided brand awareness in Canada is now 80%. This is at the same levels achieved by our U.S. business at the start of 2017, which underlines the pace at which we've gained traction there. We estimate that today we've captured a marginally greater share of the Canadian total addressable market, or TAM, in our category than we have in the U.S., as a result of being able to swiftly and successfully put in place the technology, advertising spend and logistics know-how we developed in the U.S. over many years. We're very pleased with the success we have had in Canada and the still tremendous growth that lies ahead.

Today, our UK and German businesses are growing significantly more quickly than Canada, albeit from a smaller base. We believe that we're ideally placed for future growth in Europe and are excited by the scale of the opportunity in front of us with the $300 billion TAM in Europe, being a similar size to that of the United States and Canada combined; and Germany and UK accounting for $125 billion of that.

We are more bullish on the opportunity in Europe now than we've ever been due to the responses we're seeing from customers and suppliers in the region. This traction enables us to make long-term investments in both regions, much like we've done in the U.S., with CastleGate facilities operational in both countries and our marketing team now scaling ad spend productively in Germany as a result of the customer conversion rates our site is achieving. For example, in Q2 of this year, we started our ramp of television advertising in Germany, a step we took in the United Kingdom in 2016.

We're continuing to invest heavily in our teams in Europe with over 1,400 people based there at present. In Berlin, where over half of our European head count is located, we're continuing to add great people across our teams in functions including marketing, engineering and operations. As co-founders and significant equity holders in the company, Steve and I have always run the company with long-term value creation in mind and that's particularly important with the business we are building in Europe.

We're in the early days of online penetration in the home category and we believe this long-term mindset will continue to serve us incredibly well. As ever, our investment decisions will continue to be governed by what is best for customers over the longer term and by the payback criteria we set across our business. As a result, our

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path to profitability won't necessarily come in a straight line, but we are thrilled with the progress we are making and scaling what we believe will be a large, profitable European business over time and toward our long-term financial goal as a company.

Now turning to my second topic, I'd like to tell you more about the work we are doing to capture a higher share of wallet from our customer base. On previous earnings calls, we have spoken about the steps we're taking to increase penetration of categories within our total addressable market where we have historically under-indexed, such as bathroom vanities and outdoor structures and spas. Today, I want to give you an update on the progress we are making in the mattress category and steps we are taking in a key part of our service offering, mainly financing and loyalty.

Mattresses is a category that we are very well placed to win in, but where until 2016, we had under-invested. The category was not well merchandised on our site, our product selection was lacking and our proprietary logistics infrastructure was in its infancy and therefore could not be leveraged to improve the customer experience.

Our efforts to gain share of wallet in mattresses over the last two years have been broad-based. We built a dedicated category and site merchandising team for mattresses enabling us to build an offering that is comprehensive across price points and mattress types spanning house and third party brands. As part of this, last year we launched Nora, a bed-in-a-box mattress sold exclusively on Wayfair, which targets the more premium end of the bed-in-a-box market, strengthening our offering in this product class, which had been more focused on our affordable Wayfair Sleep brand up until that point.

Alongside our own range, we have been working closely with some of the leading brands in the industry to help really bring their products to life online and equip shoppers to make their purchase in an informed and assured way. In addition to range and selection, we have been investing in the service elements that are often key components of shopping in the mattress category. For example, we offer a 100-night trial on all of our mattresses, after which customers can simply return their mattress for a full refund or an alternative mattress, putting customers at ease while making their initial purchase.

We believe the investments we have made in CastleGate and in our last mile delivery locations have also considerably improved our customer offering. For example, half of our mattresses sold in 2018 have shipped from a CastleGate warehouse. And for the mattresses, we're able to guarantee delivery to customers in two days across majority of the United States. The head count investment we are making is paying off with the mattress category today having an annualized net revenue run rate of over $240 million compared with a $100 million run rate we highlighted in our Q4 2016 earnings call, representing a CAGR of over 65% for that period.

Giving customers the best possible experience when they shop with us is the ultimate driver of customer loyalty and lifetime value, whether that is in categories that are shopped less frequently like mattresses or in other more regularly purchased categories. We are constantly looking for new ways to enhance the overall experience we offer, thereby driving increased loyalty. We're actively building a variety of loyalty products and programs as part of that effort.

An early initiative in this space was the launch of the Wayfair Card, our private label credit card in late 2015. Today, the Wayfair Card consists of over 1 million cardholders who, by the end of the year, are on track to spend an excess of $900 million on an annual run rate basis on their Wayfair Cards, with no credit risk borne by Wayfair. Wayfair cardholders visit Wayfair more frequently and spend more than three times as much with us in the first two years compared with non-cardholders with a substantial portion of their spending being incremental. We are

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also excited to be expanding our private label credit card business by customizing the Wayfair Card for each of our lifestyle brands, which we believe will drive further penetration in those distinct brands.

More recently, last month, we launched MyWay, a subscription-based membership program. With an annual fee of $29.99, members receive access to insider sales, discounts on installation and assembly services, as well as expanded free shipping and next-day delivery. We are inviting customers to enjoy an elevated level of service and value, while offering yet another reason to make Wayfair their go-to destination for the home. We are excited to ramp this program, while continually adding new benefits to increase its value to customers.

MyWay and the Wayfair Card are just two examples of the investments we are making to creating a home as easy, fun and affordable as possible on Wayfair. More broadly, these two strategic initiatives demonstrate how we are tackling big problems by building dedicated cross-functional teams and equipping them to succeed. Over the past 18 months, we've added over 30 people to our customer, loyalty and financing teams, including software engineers, marketers and business development professionals. We are following a similar approach across many areas of the company.

Now, before I turn the call over to Steve, I want to provide brief updates on two other areas. The expansion of our proprietary logistics network continues to progress well. In Q3, we opened a 900,000-square foot CastleGate facility in Dallas, Texas and recently launched last mile delivery facilities in Minneapolis and Seattle. We're now operating 27 of our own last mile delivery facilities in North America, giving us coverage of 66% of our U.S. large parcel home deliveries.

Following this expansion at the end of Q3, we had approximately 11 million square feet of space across our CastleGate and last mile delivery networks. We expect to end 2018 with approximately 11.5 million square feet of logistics space, representing an addition of 4 million square feet during the year. These long-term investments allow us to reduce our reliance on third parties and enable us over time to increase delivery speed, lower damage and costs and improve satisfaction for more and more of our customers. With the growth in revenue we are seeing both in the U.S. and internationally, we expect to invest further in our logistics infrastructure in 2019 and beyond.

CastleGate is a core enabler of our business throughout the year, and that's particularly the case in Q4 as we work closely with suppliers to ensure that we can bring customers the best possible selection and fast delivery for the holiday season. Currently, for example, our suppliers have forward positioned approximately $250 million of stock at wholesale costs across our CastleGate facilities, which represents over $1 billion of annual wholesale value at current inventory turns.

The holiday season also presents us with attractive opportunities to interact with customers in new ways, and this season we're excited to be offering shoppers a new way to experience our brand with the opening of two temporary pop-up shops today in Natick, Massachusetts and Paramus, New Jersey. Online is the core of our business, but we believe that creative retail formats can be complementary to that experience and generate insights that will further enhance our overall customer proposition.

In our pop-up stores, shoppers are able to get design tips from experts, receive advice on home improvement projects and be introduced to the many innovative features we have helped build for them to shop for the home online. Bringing Wayfair to customers in this new format at a time of year when we know that they're in market for our category offers us a great opportunity to experiment in showcasing our brand and service team members in new ways and deepen the customers' connection to our brand. Our use of retail stores, like innovation in all areas

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across our business, will be an iterative process and we'll use the learnings from visitors to our pop-up stores to determine the best format to offer shoppers in the future.

One other area that we have been experimenting with this year is sponsored products where suppliers can invest advertising dollars to give their product, whether it is for a line of seasonal decor or the launch of a new coffee table design, greater prominence with customers on our site. With over 10 million products on our platform, for more than 10,000 suppliers, making it as easy and inspirational as possible for our customer to find the product she'll love is incredibly important.

Over the course of this year, we have been testing different ways to allow suppliers to pay to achieve enhanced placement. Our focus in these tests was to closely measure the response from customers to ensure that including supplier-promoted items would be accretive to customer experience. We were pleased with the initial results both from a supplier and customer perspective and in September, the program moved from a pilot with a closed number of suppliers to general availability. We are very much in the early stages of developing this area of our business but our data-driven culture and partnership model with suppliers puts us in a strong position to scale this effectively over time.

Now, I'll turn the call over to Steve to talk about the long-term investments we are making to improve how shoppers can visualize products in their home in the future.

Steven K. Conine

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

Thanks, Niraj. This morning I would like to talk about one of the innovative technologies we have been working on that we believe will bring exciting benefits to our customers over the long-term. Technology is a core part of our DNA and has been central to our success in capturing an outsized share of consumer spending in our category as it shifts from bricks and mortar channels to online. The decades' long view we take to building our business has served us incredibly well to-date and that is particularly true in technology.

On prior calls, I have talked about the early investments we have made in our 3D and augmented reality capabilities and the impact we expect this technology will have over time on how customers shop on Wayfair. Visualization technology continues to evolve and partnering deeply with leading companies in the space is a core element of our strategy. We were early investors in augmented reality, partnering closely with Google and Verizon in releasing WayfairView on the ASUS ZenFone AR in August 2017, the first smartphone with virtual reality and augmented reality capabilities. Leveraging the same investment in technology, we were able to reach the mass market when Apple made AR widely available by launching AR support on their phones and tablets in September of 2017.

The partnerships I want to highlight today is in the field of mixed reality and spatial computing. Mixed reality couples real and virtual worlds enabling customers to interact with both physical and digital objects in their environment in real-time. Spatial computing platforms utilize user space to show them information instead of a 2D screen such as an iPhone or a computer screen. We believe this could have a huge impact on how people shop for the home online, and last year, we became the first e-commerce business to partner with Magic Leap, which is leading the way in this field. Magic Leap is a mixed reality and spatial computing company that is focused on wearable technology that enables users to digitally interact with their environments.

Last month, we showcased the application we developed for Magic Leap's spatial computing platform, Magic Leap One, at their inaugural conference in Los Angeles. The application, Wayfair Spaces, which is now available on Magic Leap's app store, enables consumers to explore a subset of our catalog and visualize living spaces

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through intuitive mixed reality interactions. It's a design experience that visually layers items onto the customer's environment via a head mounted see-through virtual retinal display creating a shopping experience that is deeply immersive and engaging.

The technology will allow consumers to select a couch, for example, and see it in their own living room to give them a highly realistic sense of how it would look alongside a rug or an armchair already in that room. Customers will be able to swap out the couch and visualize multiple options to find the perfect match for their room within seconds. Shoppers will easily be able to build entire rooms using Wayfair Spaces, visualizing how their choices will come together to create the look they love, giving them greater confidence to purchase.

Being able to create virtually finished rooms using precise dimensions in real product has many applications such as aiding interior designers in creating remote design sessions for the couple that is looking to visualize furniture in a new home. We expect this technology will take time to reach the mass market, and when it does, we will be very well positioned to leverage it to deliver a rich set of features to our customers and partners as a result of our early work in this field.

We expect that our work in mixed reality will provide benefits on many fronts beyond the Wayfair Spaces application, much like our investment in augmented reality resulted in a growing 3D product image library that we have utilized to lower visual merchandising costs on our sites. Mixed reality is just one example of the important work that our team of over 2,100 engineers and data scientists is doing to leverage technology to transform the experience we offer shoppers.

With early stage technologies, the source of future returns is often very unclear. We have seen, for example, that our early investments in augmented reality have yielded a substantial benefit to our wider business by enabling us to develop a catalog of 3D product images to use across our business. Today, our site merchandising teams increasingly create rich lifestyle images digitally for use throughout our site without the need to ever assemble those products to be shot in a photo studio. Without our initial investment in augmented reality, we would not have developed this capability at the pace we did. By taking a long-term view and partnering with leading technology companies, we are taking steps today that will continue to keep us at the forefront of e-commerce for the home in the years to come.

I will now turn the call over to Michael to discuss our Q3 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 the IR site.

In Q3, our Direct Retail business increased 43% year-over-year to $1.692 billion, representing year-over-year dollar growth of approximately $510 million. Our total net revenue increased 42% year-over-year to $1.706 billion. Our KPIs which we report on a consolidated global basis continued at healthy levels in Q3 with many achieving all-time highs. In addition to the growth and the size of our active customer base in Q3, we're also seeing purchase frequency, as measured by LTM orders per active customer, continue to increase reaching 1.84 in the quarter. Additionally, orders from repeat customers, continues to grow more quickly than orders from new customers, and accounted for approximately two-thirds of orders placed in the quarter.

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Turning now to our U.S. business, Direct Retail net revenue increased to $1.460 billion in Q3, up 41% year-over-year, representing year-over-year dollar growth in the quarter of approximately $430 million. Direct Retail net revenue from our International businesses in Canada, the UK and Germany, collectively increased to $232 million, up 58% year-over-year. As Niraj highlighted earlier, we're thrilled to see customers increasingly shopping with us as we invest to bring them the best possible experience in shopping the home category online, both in the U.S. and internationally.

I will share the remaining financials on a non-GAAP basis, excluding the impact of equity-based compensation and related taxes, which totaled $36 million in Q3 2018. For 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 $393 million or 23.1% of net revenue, consistent with our near-term expectation for gross margins in the 23% to 24% range.

On the Q2 earnings call, I spoke about the attractive opportunities we're seeing to invest ad dollars in the U.S. and internationally. As Q3 progressed, we continued to see compelling opportunities to lean in and invest further advertising spend behind the strength of our customer KPIs, while maintaining our overall one-year contribution margin payback target. This resulted in Q3 advertising spend of $203 million or 11.9% of net revenue, broadly in line with Q3 last year. We are extremely excited to be able to invest in the analytical and aggressive manner that we are today as a result of the customer conversion and repeat levels our sites are achieving.

In any given quarter, the scale of our ad spend will vary depending on the opportunities we're able to unlock. While we therefore expect our long-term historical trend of ad spend leverage to continue despite the negative mix shift impact of our International business, as we have said every quarter, we will not manage the business to exhibit that leverage in any given quarter.

With a $600 billion TAM and a proposition that is clearly winning with customers and with suppliers, we think it would be extremely shortsighted to forego the high ROI opportunities that we have put ourselves in a position to be able to capture. Accordingly, as we look out to Q4, we remain comfortable leaning in on ad spend as we did in Q3 and therefore expect overall ad spend as a percent of net revenue to be approximately in line with the level of Q4 last year. Our non-GAAP selling, operations, technology and G&A expenses are driven primarily by compensation costs, and in Q3 totaled $235 million.

In the first three quarters of this year, we have hired at pace adding great people to teams across our business as we continue to improve our customer offering in the U.S. and internationally, and win outsized market share. Across 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, we have a large number of initiatives that are showing extremely high levels of return from incremental head count.

As I highlighted on our last earnings call, throughout this year, we have been able to recruit high caliber people at scale, capitalizing on the strength of our employer brand in Boston and elsewhere. In the third quarter, we added 1,200 net new employees for a total of 10,908 employees as of September 30, 2018. Over 850 of those net new hires, excluding the impact of summer interns and co-ops, were in OpEx areas such as engineering, marketing, merchandising, product, operations, including logistics leadership and technology.

We exceeded even our expected level of hiring in Q3, resulting in approximately 2,000 net new OpEx adds in the first three quarters of this year. We're thrilled to have strengthened our teams in this way and to be putting

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ourselves in the best possible position to continue to scale our business successfully, by investing near-term EBITDA flow-through in initiatives that we firmly believe will pay back in the future.

The level and timing of our investment decisions including hiring are not determined by factors such as near-term revenue performance or by quarterly or year-end results, but purely by what it takes to serve our customers and when it makes the most sense to make that specific investment in order to best achieve our long-term ambition. We expect that our recruitment success in the first three quarters of this year will result in the sizable sequential step-down in OpEx hiring in Q4 that I mentioned on our last earnings call.

One point to note is that with many of the Q3 hires joining the business later in the quarter, the full impact of the elevated hiring in Q3 will only be seen in Q4 OpEx spend. Moving through 2019, we expect OpEx hiring to run more in line with lower Q4 2018 levels than with the elevated levels seen earlier this year and to run at a rate lower than our revenue growth and drive OpEx leverage over time.

As we've said in recent earnings calls, the build-out of our CastleGate and WDN facilities in the U.S. and internationally puts us in a great position for continued growth, but does mean that unutilized rent continues to weigh on our P&L in the $5 million to $8 million range per quarter in OpEx this year. We feel incredibly bullish as we look across our business and as a result of that, we're making investment decisions today that are governed by our future ambitions for the business rather than the profitability achieved in any particular quarter.

Turning to profitability, adjusted EBITDA for Q3 was negative $76 million or negative 4.5% of net revenue. Adjusted EBITDA for the U.S. business in Q3 was negative $26 million or negative 1.8% of net revenue and adjusted EBITDA for the International business was negative $50 million. Non-GAAP free cash flow for the quarter was negative $59 million based on net cash from operating activities of $8 million and capital expenditures of $67 million. CapEx spending was 3.9% of net revenue in Q3. For Q4, we expect CapEx to remain in the range of 3% to 4% of net revenue. As of September 30, 2018, we had approximately $525 million of cash, cash equivalents and short and long-term investments.

Now, let me outline our thoughts on guidance for Q4. The fourth quarter is always the toughest to guide because sitting here on November 1, there is disproportionately more of the quarter in front of us than any other quarter of the year. In this quarter, that is exacerbated by a clearly more volatile market environment and an increasingly opaque view of consumer sentiment.

As we have outlined on previous calls, we believe that Wayfair is incredibly well positioned to continue to win and thrive in a more difficult economy, but any substantial consumer spending change would obviously have short-term impacts on our results. This backdrop makes guidance setting for Q4 this year particularly challenging. The other challenge is that entering the holidays with any uncertainty can increase the promotional intensity in the category driven by traditional retailers who hold massive inventory.

We are protected by our business model, and as you all know, source substantial discounts from our supplier partners as we enter the holidays to be comfortably market priced. We expect gross margins consistent with the 23% level of recent quarters, but we will remain market priced to serve our customers and as such there is some risk that gross profit margins could fall below that level.

For Q4 2018, we forecast Direct Retail net revenue of $1.905 billion to $1.950 billion, a growth rate of approximately 34% to 37% year-over-year and representing year-over-year Direct Retail dollar growth of approximately $500 million. For transparency, order-to-date Direct Retail gross revenue is running at the top end of this range. Further, we expect U.S. Direct Retail year-over-year growth in the range of 32% to 35% and

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International Direct Retail year-over-year growth in the range of 50% to 55%. We forecast other revenue to be between $15 million and $18 million for total net revenue of $1.92 billion to $1.968 billion for the fourth quarter.

As stated earlier, we anticipate ad spend as a percent of revenue this quarter to be at similar levels to Q4 last year and we also expect to have lower levels of hiring this quarter compared to Q3. However, we expect to see the full roll through of the accelerated hiring over the last few quarters and in particular late in Q3 in the Q4 P&L. And as such, OpEx costs should continue to de-lever year-over-year in Q4, but show some modest sequential improvement.

For consolidated adjusted EBITDA, we forecast margins of negative 3.8% to negative 4.1% for Q4 2018. We expect international adjusted EBITDA to be negative $55 million to negative $60 million in Q4 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 of negative 1% to negative 1.5% as we continue to invest in penetrating the very large addressable market we see in our category in our primary market.

For modeling purposes for Q4 2018, please assume equity-based compensation and related tax expense of approximately $45 million to $47 million, average weighted shares outstanding of 90.4 million and depreciation and amortization of approximately $36 million to $38 million.

As the markets shift to online in our $600 billion category continues, we are extremely pleased with all our customer metrics and KPIs with repeat rates at all-time highs and our continued share taking. It is on the wave of that trend and the positive response we continue to see from our customers that we are investing across our business to further cement our brand and continued future profitable growth at scale. Volatile markets and consumer sentiment will ebb and flow, but the deep repeating relationships we are building with our customers and their desire to buy online from Wayfair is the long-term asset and future profit generator we are creating.

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 momentum in our business and our ability to capture the opportunity we see ahead of us both in the U.S. and internationally. We're delighted with the progress our company of almost 11,000 people is making in bringing customers the best possible experience in shopping the home category online. Customers are rewarding us with their dollars as they increasingly benefit from the investments we have been making in our logistics infrastructure and deepening the products and services we offer them and in strengthening our proposition and brand awareness internationally.

All of our efforts are focused on continuing to improve what we can offer shoppers over the long-term so that we can capitalize on the secular tailwind from offline to online in our category and grow substantially in excess of the online market growth rate for the home category.

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

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QUESTION AND ANSWER SECTION

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

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Hey, thanks. Good morning, everyone. Congrats on the continued strong revenue growth and improving KPIs. I did want to dig into the EBITDA for the quarter, however, your total EBITDA margin came in below your guided range despite the sales beat. Michael, I know you mentioned head count maybe a little bit above. But could you dig into that a little bit for us and help us understand where some of the profitability measures missed a bit?

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

A

Hi Peter. It's Niraj. Thanks for your question. I guess, on this one, why don't we start with Michael given the nature of the question?

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

A

Yeah. Hey, Peter. I think two key areas to look at in terms of EBITDA, both of which I mentioned in the top track as well. One is ad spend. As we talked about at the beginning or last quarter's call, we did expect to show some ad spend leverage.

But as we went through the quarter, we continued to see great opportunities within our paybacks. As everyone I think is aware, we look for on average one-year payback on new customer acquisitions on ad spend. And we have said time-and-time again if in the middle of the quarter we see those opportunities and the team is finding that, we're going to go lean in and take advantage of it, and we're always going to do it from the perspective of what's the right long-term return for the business as opposed to sort of trying to make a particular number even if it's something that we guided. So I think you had ad spend basically flat year-over-year as opposed to showing 30 or 40 basis points of leverage.

And then on the other side is the OpEx head count hiring. It came in stronger than we expected. We feel extremely good about the people we've added to the team, and how we're growing, the folks who are faced off against dozens and dozens of initiatives that are all about our future growth.

And as we talked about I think extensively on the last call, we're excited about that team of people we're adding. We're going to add them as we can. The employer brand has been very strong. But at the same time we are going to step down the rate of net new ads in OpEx in Q4. We planned that starting a quarter ago and we're sort of in the middle of that process right now in the fourth quarter. And I think those two key factors were really the drivers of incremental expense versus even the sort of good revenue performance that led to the higher EBITDA loss.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay. Thank you very much.

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

A

I think that basically – go ahead, Peter.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

I did have a question specifically for you. So getting a lot of investor questions around tariffs. Curious on what your initial supplier discussions are like, if with the 10% tariffs if you're starting to see any price increases on your website. I understand you guys aren't directly impacted but could you help us understand if there's any concern of demand destruction, if there's some general price inflation across the marketplace?

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

A

Yeah, so obviously the 10% – so there's basically like three waves, right. So the first wave that went into effect earlier this summer was on raw materials, but the raw materials had some trickle through effect on steel and some of the other materials. Then you had the 10% go into effect in September and then there's the – the 10% goes up to 25% at the turn of the year. And so what we've been hearing from suppliers is that it does create a period of discontinuity where they're all going back into their supply chain seeing what cost they can take out because obviously they would love to not raise prices.

And the dynamic we have which is a really advantageous one for us is that as a platform these suppliers are effectively competing with each other to take care of the customer, and so they know that on a relative basis even though something has happened, what you don't want to do is put yourself in a disadvantaged position relative to the other suppliers who are all trying to figure out how to contain their costs. So that gives us obviously a benefit versus if we were effectively a middleman in which case that if things go against us we're obviously hurt.

In terms of price increases, I think the reality is that the amount of inflation in raw materials coupled with the tariffs, it is driving price increases, and I think what we're seeing is that suppliers are all trying to feel their way through what exactly is going to happen when, how much can they take out in cost, and what is going to be then the net price increase they need to pass through to kind of keep things working as well as possible.

So we're definitely hearing a lot of these conversations. And I think I would kind of liken it a little bit to what happened with Brexit, where you had – in that case there was no notice period, last year the tariffs had a notice period, but there you had the – the FX on currency changed dramatically and the suppliers were generally buying products denominated in dollars or the materials denominated in dollars, and there you had a fairly kind of abrupt period of mayhem where suppliers are trying to figure out what to do.

And then coming out of that, we were significantly advantaged, but in the mayhem period you found some suppliers sort of lose to other suppliers and some suppliers be more aggressive on price increases quicker than others and then that obviously hurts them because their retails go up. So that's kind of what we're seeing now.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay. That's helpful feedback. Thanks very much and good luck this holiday season.

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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 John Blackledge from Cowen. Your line is open.

John Blackledge
Analyst, Cowen & Co. LLC

Q

Great. Couple questions. Niraj mentioned that sponsored products became – I think they became widely available in September. Maybe could you provide some color on the ROI for beta customers' experiences with sponsored products. And then any color on the ramp of sponsored products, how it might impact 4Q 2018 longer term?

And then separately on EBITDA, so the U.S. biz based on your guide will run about a minus 1% or so for full year, EBITDA margin in 2018. Can you kind of frame this number versus 8% to 10% long-term EBITDA margin? Like any color on how you get from minus 1% at $5.5 billion or so of annual U.S. revenue to that kind of long-term bogey? Thank you.

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

A

Sure, John. Thanks. This is Niraj. Let me try to answer them and then Michael can maybe chime in if he has some other thoughts to add. Now first on sponsored products, so the ROAS, the return on ad spend for the suppliers in the kind of beta we did, and in the initial launch period since we made it generally available has been pretty much off the charts. A lot higher than what they're accustomed to elsewhere which, frankly, to us, means that as more participants enter, the economics for everyone can get better because the ROAS probably doesn't even need to be that high for folks who want to compete because what we're hearing is it's much higher than what they see elsewhere.

So that's one of the things that makes us feel good about the product. It's the combination that the suppliers are seeing great economic return, they're finding it easy to use and they like the reporting and we're going to do a lot more on that side.

And the customer experience has been protected, and the customers are basically reacting very positively and a lot of the things that we can do around understanding customers and personalization and other things can help make sure that the customer experience is a positive one versus sometimes you can have highly lucrative advertising that could create a negative customer experience that you need to be very careful about for long-term effects. So that one we're – it's in a great spot.

In terms of your timing question on the benefits in this quarter and long-term, the reality is we think it will take a little while to ramp up. So we obviously – there's volume there and it grows, but the volume starts relatively small, and I think the real economics for everyone involved get good as it ramps and so we're in a ramp phase, but I don't think of the ramp as not in a quarter, but as many quarters. And as it plays out through next year and

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forward, I think we'll start seeing it be a meaningful contributor. But I wouldn't think of this quarter as being a particularly large contributor.

On your EBITDA question, I think the important thing – so I'll give you a few different thoughts that together sort of might answer your question. One of the important things, because you kind of tied it well, if you're minus 1% at $5.5 billion, how does it play out? And I really encourage you to think about the answer and realize that those two things, you need to decouple those two statements.

So in other words, scale alone doesn't unlock the high EBITDA. So in other words, we could be at $5.5 billion and today we could be at that target range, and it actually wouldn't be that difficult. To get to that target range, all we would need to do today is do a few things. One is we would basically take down the new customer growth. Instead of saying we want a 12-month payback, we could say we want a 6-month payback.

If you look at the economics of how much of the ad spend is on new customers and obviously the ones that pay back in six months cost a lot less than the ones that pay back in 12 months, you could take a significant portion out of the ad spend. You could take half of the dollars out of the ad spend, still be growing quite nicely and you'd be running much shorter paybacks and because all that money, the advertising you expensed in the current period, you get payback over a longer period, all that money would accrue to basically profitability today. But now if you look out two years or three years, your active customer base is smaller. So in the long run you're just a smaller player but today's profit shoots way up.

The second is on OpEx. If you think about what we're doing with the aggressive expansion of the CastleGate facilities and all this unutilized rent, and all the facilities that are running at basically heavier cost than long-term because we've leased a building and not just the unutilized rent but also the team we have put in there to run it and we're paying for the full team but the volume is not going to the building yet, that's all cost that runs through our P&L today, but we're excited about what it would look like.

But the profitability comes out at a much higher level of utilization than you have today despite the fact that it's growing quite nicely, it's because we're expanding it quite aggressively because we know we can put a lot more volume through it as you look out to next year and the year after. The other place in OpEx is all these teams. When I talked about design services for example, and I talked about – we talked about some of these different category teams and we talked this time about loyalty, and we talked about the financing. And these teams you say, well, a couple dozen people, that's not a big deal. Well, the key is a couple dozen people is super high ROI on that one thing.

Now, the trick is we're doing dozens of these things. So a couple dozen people times dozens or 40 or 50 of these teams, that's a lot of people. And that's a lot of cost. And so on one hand, the ramp of hiring has been significant, while the plus side is these folks are now on these efforts, so when you roll into the future there's huge gains, but again you pay for everyone right away.

And so the other thing you can do is you can say, well, why don't we just do half of those things, let's just pick half, let's pick the half we're more confident on or a little bit low hanging fruit or you know what, if you can't do that on the category side, they are all big opportunities, let's just pick half of them, pick half the categories, don't to the other half, and you could. And again, today's EBITDA would shoot way up but then what would happen is the gains you get one, two, and three years out, you would only get those in half the categories and then half the categories you wouldn't get those in.

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So there's a bunch of things in our P&L and there's a bunch of things on gross margin because gross margin gets depressed because of the mix effect of International, for example, which is a huge cost, you're talking here about just the U.S. but gross margin has mix even within the U.S. where we have new things, new categories that start low gross margin that are scaling up, and with things that are expensive there and then on the transportation and logistics depresses the gross margin. So if we did less there, the gross margin would rise there. And frankly from a buying power standpoint, there's categories where we could just say, hey, there are things we can do in the near term that basically let us take more margin but that's [indiscernible] (50:44).

So that's a longwinded answer but the first thing to think about is just simply that the EBITDA today could already be there if we just make different decisions about our time orientation, about what time we want to see profitability in. Our view of what we'd like to do is see that 8% to 10% be against a very large number and the large numbers because we're the big winner in the space, and so we're basically getting our full margin while scaling very aggressively and continue to take share because of the moat we built, because of the experience. And therefore we get the customer loyalty.

And so if you think about what we're doing, it basically does all that. So from a trajectory standpoint, if you think about 2014, the U.S. started that year negative 6%, negative 7% EBITDA. And it's got gotten up to basically, I call it, breakeven, but let's call it negative 1%. Basically because the economics of the model drive a lot of incremental EBITDA as you scale the kind of rates we've been scaling at because the contribution margin just under 20% of every revenue dollar keeps flowing through and it either needs to be spent on head count or advertising.

In a period of time like right now where head count has a bit of an acute step up and advertising is not showing leverage, it has shown a lot of leverage since 2014, but right now it's not showing leverage because of the mix shift of international, the mix shift in new efforts like Perigold coupled with what Michael pointed to you, which is that we did have a big opportunity to lean in, you basically for this period of time you get less flowing down. But that will revert fairly quickly as you go through a few quarters because of the OpEx hiring plans we already put in place start having us growing OpEx a lot slower. And then frankly, advertising will continue to show leverage over time. So that's kind of like a longwinded answer to your question. I tried to hit on a few key things I think are important to understand, hopefully that's useful. Let me – Michael, do you have anything you want to add?

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

No. I think you covered it.

John Blackledge
Analyst, Cowen & Co. LLC
A

Thank you. That was helpful. Appreciate it.

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

Thanks, John.

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

Maria Ripps
Analyst, Canaccord Genuity, Inc.
Q

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Good morning. Thanks for taking my questions. Can you refresh us on your house brand strategy? It seems like house brands increased substantially in the [indiscernible] (52:51) just in a couple of years. Could you talk about some of the advantages of this program both to you, consumers, and suppliers? And to what extent does it help margins and where do you see house brands revenue contribution shifting over time?

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

A

Yeah. Thanks, Maria. So just to recap what house brands are for everyone and then I'll kind of give you some specific color on your question. So what we do, so we have certain categories where consumers do know the brands. So something like small electrics where they know brands of coffee makers or in plumbing where Kohler, Moen, Delta, Grohe, these are brands they know. Well, obviously in those cases, large appliances [indiscernible] (53:33) we work with a supplier, we're promoting their brand.

The reality is those categories are a very small portion of our total business. So the vast, vast, vast majority of our business, think about bunk beds or lighting or pillows or decorative accents or effectively all the sub categories, furniture or bathroom vanities, the consumer does not know any brand names. And what they really want to do is they want to navigate the selection to find something that has the right style for them that is good quality based on the price point that they want to be in, that the aesthetic really speaks to them, and is the look they want to have in their room or in their finished space.

And so there what we found is that, what we can do is, we can create a whole [ph] anthology (54:22) of brands, so we have over 75 of these brands, and each brand can speak to a specific quality, style, price point spot in the market, the way a good home brand would do. And what we can then do is we can curate items from our suppliers into the appropriate brand where they fit. And we can then do environmental imagery of rooms and spaces which allow that item to come to life a lot more than a product silhouette or an item that's in a space that maybe doesn't fully speak to that item.

And in our case when we create these spaces, everything is shoppable, so in the brand it's not just a brand of sofas, it's a brand of – it's a lifestyle brand. It has the sofas, it has side tables, it has rugs, it has lamps, it has decorative accents. And therefore the whole – every item is shoppable. What happens then is we've created brands that consumers find easier to shop, the suppliers are perfectly happy because they really want to just move volume of products, even in brick and mortar they're accustomed to the brand not being front and center. They're accustomed to really just trying to have the right item with good price value, right. And then for the consumer who doesn't know what they're looking for, it makes it easier for them to navigate.

So the way to think about the benefits, the benefit to us is that we help customers navigate and find an item they look – they want to find that they love. Second we get away from direct price competition on an item. We get to take advantage of assets we have like our 3D modeling capability to render photography in order to create these merchandising benefits, which is actually kind of a competitive advantage. And then for our suppliers, they really love it. Because the less competition they have between their distribution channels the better from their perspective.

So in other words, if Wayfair is showcasing their items in a way that drives more sales, they're excited because one of their goals is volume. And if we do it in a way that you actually don't even know that this item is from that supplier, they actually like that as well because they're big brick and mortar customers, where there are other customers who maybe feature an item in a catalog or what have you, those customers don't feel like Wayfair's competition. And so it's sort of – it's something that works well for everybody and really starts with the consumer

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having the significant benefits around navigation and bringing the item to life. And so the conversion goes up as well for us.

So there's a lot of benefits for all three. In terms of share, it was over 60% was the last update we gave you, and it's something that continues to grow. So where can it end? Well, higher than where it's been. So higher than 60%. Obviously we have some categories that are frankly branded categories, large appliances I mentioned, small appliances I mentioned, plumbing. So it will never get to 100%, but it's going to be the vast, vast majority of our business.

Maria Ripps
Analyst, Canaccord Genuity, Inc.

Q

That's helpful. Thanks a lot.

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

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Hi. Good morning. Thank you for taking my questions. So two questions. First off, I guess first for Michael, in your prepared comments, you discussed the overall macro environment. It sounded like you were indicating some concerns out there. So the question I have there is, are you seeing something now in the macro environment that is weighing upon your business, or you just more or less the same simply given all that's going on in the world, there could be worries in that everything for that reason you mentioned as we head for the holiday season?

And then my second question for Niraj, just on the MyWay subscription plan, maybe a little more color on that, the program and how we should over time expect that to enhance the key metrics we watch for your business. Thank you.

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

A

Thanks, Brian. Look, on the macro environment, I think a part of it is that it's just – there's so much volatility and noise right now, right, it's just an extremely uncertain period. And so when I sit down and sit with the team, we try and figure out what guidance is and you're trying to look out a few months, particularly a few months during the holiday period, and you've got a lot of noise leading up to elections and all that other stuff, it just makes it harder.

And so it's not a specific thing that I'm pointing to, whether there's some sort of softness in our business that we've seen that we would point to. And remember one of the challenges or I guess the opportunities is the big driver in our business is the shift online. And so I think if you're in a business that's 3% grower, you're more likely to sort of instantly feel and understand and perceive macro environment changes.

If you're in a business that's 40% grower, you're not – and a big part of that growth is driven by the sort of massive shift, right, the sort of systemic movement of people from one shopping methodology to a whole another one, you're less – you're going to feel that less. And so part of my job is a little bit of reading the tea leaves of what the macro environment is as a whole and trying to understand how that may impact our business. But it's not tied to some specific thing that I would put my finger on.

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

A

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And then on the second – Brian, on the second question about MyWay. So here is the way we think about it. So our whole focus on our business is to have the best customer experience so that we basically earn loyalty from our customers. And so all these different initiatives we have are basically meant to ease our customers' life and add value to their experience and make it more engaging so that they frankly come back to us more and more. And that's what we've been seeing happen.

So then if you think about a loyalty program, a loyalty program is effectively a vehicle to help further that by effectively rewarding a customer with a bunch of benefits that make it advantageous for them to want to spend more time shopping with us, and buying more from us relative to fragmenting that spend elsewhere.

And so there's a couple different kinds of membership programs out there, and the most common kind out there is effectively one that provides customers discounts in exchange for some sort of membership kind of either earned or paid for. And we're not a fan of those programs because effectively any time you discount, you of course can get a little pop in revenue. It's very hard in the long run to have that be the basis for loyalty because it's the same thing as trying to be a price leader. You don't really earn long-term loyalty by being a price leader, unless you believe that structurally you can always be the lowest cost player.

And so what you've seen and you're seeing this in the current environment, most of the folks who are offering discount led membership programs are challenged because the truth is that lifted their everyday price in order to fund it. And you're seeing how they structurally get themselves challenged when they do that. So our view is fundamental long-term loyalty is earned because you actually are providing the customer with more value and the value is not just price.

Price is one significant element. And so every day we want to offer good value. But there's actually a lot of additional value around the experience, around the quality of services or access to financing or delivery experiences or on kind of unique advantages like perhaps that you could get access to major events a little earlier, things that are maybe not financial in nature but actually go pretty far to get the customer excited about wanting to spend more time with us and also allocate more of their spend to us.

And so what we're trying to do with MyWay is basically create a series of benefits that really get at the fundamental reason why Wayfair is a superior experience, and to offer those to customers in a way that's differentiated to get them to want to participate. And if you think about the key metrics we would look to see, we look to see our frequency of purchase go up, we'd look to see our total spend per customer per year to go up.

Those are the same metrics by the way we've always looked for it to go up. And the purchases per year on a trailing basis of up to 1.84, the spend per customer is up to $443. Well, both of those are basically all-time highs, and that's even with the mix shift drag from the newer businesses which weight those down.

So we're having good momentum on those, and repeat has grown faster than new every quarter that you guys have and up to 66% of the total is now repeat customers. And so we think a really high quality loyalty program will kind of further facilitate that. And that's how we've designed it and what we plan to continue to do to kind of hone it and advance it and those would be the metrics we continue to expect to see climb over time.

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

That's very helpful. Appreciate all the detail. Good luck for the holiday.

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

A

Thank you.

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

A

Thank you.

Operator: This will conclude our Q&A question session at this time. I turn the call back over to the presenters for closing remarks.

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

Well, everyone, thank you for joining this morning. We're definitely very excited about the business and our future prospects, and we talked a lot about the things we have underway. So anyways, have a great rest of the year and then thank you again.

Operator: Thank you, everyone. This will conclude today's conference call. You may now disconnect.

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