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Wayfair, Inc. (W)

Q1 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen. My name is Suzanne and I will be your host operator for this call. At this time, I would like to welcome everyone to the Wayfair Q1 2019 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.

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

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

Good morning and thank you for joining us. Today, we will review our first quarter 2019 results. With me are Niraj Shah, Co-founder, Chief Executive Officer and Co-Chairman; Steve Conine, Co-founder and Co-Chairman; and Michael Fleisher, Chief Financial Officer. We will all be available for Q&A, following today's prepared remarks.

I would like to remind you that we will make forward-looking statements during this call regarding future events and financial performance, including guidance for the second quarter of 2019. We cannot guarantee that any forward-looking statements will be accurate, although we believe that we have been reasonable in our expectations and assumptions. Our 10-K for 2018 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, Julia, and thank you all for joining us this morning. Today, I would like to provide a few updates on some of the exciting areas we are investing in and the progress we are seeing across the business. In Q1, Direct Retail net revenue grew by $542 million or 39% year over year. And total net revenue grew by 38% year over year. We are thrilled to continue our strong record of year-over-year dollar growth as the market for homes continues to move online and customers increasingly reward us with their dollars.

Clearly, our offering of broad selection, inspiring visual merchandising and superior customer service and delivery are resonating with customers, particularly as we see ongoing improvements to the customer experience as a result of the investments we have been making. Steve and I touched on Canada and Europe at length during our last earnings call. So, today, I will focus primarily on our two other large investment areas, our logistics network and the hiring we have done to deepen our offering in the categories within our addressable market where we have historically under indexed.

I also will briefly touch upon the success of our second Way Day event last month and address some of the questions about our new retail store that is opening later this year. Again, our international business continues to perform and we continue to believe in the long-term market opportunity and our ability to succeed in these geographies, leveraging our playbook developed in the U.S. over many years and building the best possible experience in the home category online. Mike will also touch on the performance of our international business later on this call.

First, let me start with our logistics network. As I described on our last earnings call, we finished 2018 with approximately 12 million square feet of space in North America and Europe across our CastleGate and WDN facilities. And in 2019, we expect to add approximately 5 million more. Of the 5 million incremental square feet, 3 million is expected to come from new U.S. CastleGate warehouses including a warehouse in Savannah, Georgia that opened just a few days ago and two warehouses we are planning to open later this year in Jacksonville, Florida and Lathrop, California.

If you think back to the beginnings of the CastleGate business a few years ago, we started with two warehouse locations in Kentucky and Utah, which gave us broad coverage of the U.S. population with two-day shipping speed for small parcel items shipped from these facilities. As our CastleGate volume grew such that container-direct induction by suppliers became more economically feasible, we added warehouse locations in coastal areas next to major ports of entry such as Cranbury, New Jersey and Perris, California. The close proximity of these locations to the ports and to major coastal population areas allows us to minimize inbound and outbound transportation costs per order over time as well as increase delivery speed to customers with Cranbury and Perris being less than 70 miles from New York City, Philadelphia and Los Angeles.

In addition to these benefits due to scale, we are also increasing the sophistication of our network and offering a variety of inbound supply chain services to our suppliers, such as ocean freight and dredge. The addition of the

Savannah, Jacksonville and Lathrop warehouses in 2019 is driven by continued CastleGate growth and capacity needs.

As we disclosed on our last earnings call, the dollar value of U.S. small parcel revenues being shipped from the CastleGate network, continues to grow at pace, almost doubling in Q4 2018, compared to Q4 2017, and accounting for approximately 26% of U.S. small parcel revenue in Q4 2018, up from approximately 19% in Q4 2017. While our initial push from suppliers was focused on small parcel volume, we are now seeing significant uptake of large parcel volume into CastleGate as well.

Specifically, in Q1, approximately 14% of our U.S. large parcel revenue were shipped from the CastleGate network. Going forward, we expect to see continued gains in both large parcel and small parcel U.S. CastleGate penetration.

The penetration in our international markets is further behind, given the relative maturity of our international business compared to the U.S. However, we are seeing gains in CastleGate penetration in these international markets as well. And in fact, later this year in the UK, we plan to open a second CastleGate warehouse, which will measure over 1 million square feet.

In our WDN network, we are now operating 38 last mile delivery facilities, giving us coverage of approximately 75% of the U.S. large parcel home deliveries with the recent additions of Louisville, St. Louis and Pittsburgh.

Now, turning to my second topic. I would 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've spoken about the steps we are taking to increase penetration of categories within our total addressable market, or TAM, where we have historically under indexed. We've gone through a few different examples over the past several quarters including bathroom vanities, outdoor structures and spas, mattresses, lighting and so on.

Today, I'd like to cover the storage and organization category as yet another example of how we invest in head count to go after these opportunities with our defined playbook. The storage and organization category is large, fragmented and is continuing to shift online as part of the broader home category. It spans all rooms of the home, including the kitchen, bathroom, closet, office, laundry room and garage, giving us the opportunity to have multiple touchpoints with consumers within this single category.

Reorganizing a home is typically a lower consideration, lower cost and more frequently undertaken activity than redecorating and as a result is a great opportunity for us to engage with customers on Wayfair's offering. Q1 is a key time period for this category as customers look to clean up from the holidays and reorganize their homes in the New Year. We therefore tailor our promotional calendar to promote organization and storage solutions for our customers during this period through our January home storage solutions sale and again in March as they begin spring cleaning.

We believe we are positioned to win share of wallet in this category as a result of the platform we have built and the category specific investments we are making to best inspire and serve customers as they shop for storage and organization solutions.

Over the last 18 months, we've built out the cross-functional teams working on this category from 15 to 35 people, principally in category management, merchandising and operations roles. One of the first areas that team focused on was building out a best-in-class assortment across all rooms of the home. Selection is important in this category because customers have varying tastes and size requirements and our inventory light model has enabled us to carry an expansive product offering of approximately 56,000 items from closet systems to shoe racks to food storage. With increased assortment comes the need to ensure customers have an easy and fun experience finding the right product.

To that end, our merchandising teams have been simplifying the range we offer in many product classes by introducing our Wayfair Basics house brand to help customers find for example the best value low-cost food storage containers without having to assess a large number of options. We've also taken a merchandising lens to the assortment and thoughtfully crafted how we present the attributes of these products calling out the differentiating features to help shoppers narrow down options based on their specific needs.

As an example, a customer can now filter her hanger selection by intended use, such as pants versus dress, pack size and product features such as non-slip hangers, fully rotating hooks, hooks with clips and so on. Our teams have also been working hard on guiding the customer on where to begin her storage and organization project. Customers often have the desire to organize a room, but can be stumped on where and how to begin. Therefore, inspiration can really matter in this category.

Rich visual imagery is a key part of the process and by providing customers with inspirational imagery of a successfully organized and well merchandised closet, laundry room or a garage, we give them greater confidence to buy. For example, we are introducing a garage wall configurator that allows you to visualize garage storage systems in your home, providing a sense of scale, design and functionality that is extremely difficult to visualize otherwise.

Size and scale can be complicated to communicate online, but are important in this category. We are investing in dimensional imagery to help customers quickly get a sense of how large the product is and identify the optimal size for their needs. As we have discussed on prior calls, we are also incorporating 3D models of various products into lifestyle images and our augmented reality viewing room functionality to further aid visualization.

As the category is scaled, we have benefited from increased customer analytics and feedback and have been able to further tailor our customer offering. For example, in looking at the product terminology that suppliers typically use, it was clear from our data and our in-house focus group tests that the customer often did not understand these terms such as casters, full access or framed for cabinet organization product classes.

To better educate our customer, we updated many of our filtering attributes to more customer friendly language and launched enhanced visual filters for kitchen and garage storage products. For example, you can now visually search for trash cans using a filter for the opening mechanism and sort by step on, swing top, motion sensor or open top.

As is the case with many of our categories, our CastleGate infrastructure has been a key enabler of what we can offer customers and suppliers in this category. We are growing the proportion of our assortment that has at least a two-day delivery promise or better. We have also built bundling experiences that allow our customers to find even better deals if they buy products in multiples. This allows us to shift low price point products with better unit economics as we ship all items in one box, while also offering a better value to the customer such as the 3 for $50 home storage offering we continuously run on the site.

We are very pleased from the early results we are seeing from these steps with storage and organization category gross revenue at more than $150 million run rate in Q1 and growing faster than the company overall. We've made great progress in the storage and organization category over the last couple of years and we're delighted to see customers increasingly turn to Wayfair for their broader set of product and service needs across home. These results add continued conviction to the head count investments we are making to further penetrate our TAM in 2019 and beyond.

Finally, I wanted to provide a brief update on our second annual Way Day event that took place in April. Building on the success of Way Day last year, this year we extended Way Day to 36 hours and expanded coverage of the event to include all of our international sites as well as AllModern, Joss & Main and Birch Lane.

To give you a sense of the scale of Way Day and the breadth of selection we offer, we sold about 29,000 bar stools; 17,000 planters; and 1,400 dog beds. And sold an item in a flash deal every 0.9 seconds.

Like all of our major promotions, we work with suppliers in advance to source wholesale product cost discounts that allow us to offer customers incredibly attractive prices. In addition to discounts on products, we have also offered customers expanded free shipping offers and triple rewards for all purchases made with the Wayfair credit card.

Flash deals were a new feature during last year's Way Day. And this year, we expanded the number of flash deals and also added new features such as Wayfair on Air, the live stream of video product reviews on site; and Share and Save, where customers can unlock savings by sharing deals on social media.

We also ran a targeted marketing and PR campaign, which was extremely successful during this period, including an omni-channel campaign centered around our national television spot that was mirrored on all marketing channels. As you can tell, it was a large effort by all our teams to put on this event and is one we are very proud of.

Way Day is also a special event inside Wayfair for our employees. To make sure that our many incredibly hard working employees in our warehouses and call centers know how important they are to our ability to deliver and serve our customers, many members of our leadership team in Boston traveled to our field locations during Way Day to show their support. We also pitched in to answer customer phone calls and fulfill customer orders in our CastleGate warehouses during this period of particularly heavy volume.

Though, most of us from Boston were not nearly as efficient as our talented field organization, we were able to bring some energy and support while that team was working to make sure that every customer expectation was fulfilled on Way Day.

Way Day 2019 was a tremendous success as we once again broke our record for the highest revenue grossing day in our history. Like last year, our new and repeat order mix during Way Day was roughly similar to other days throughout the quarter. We now have a year's worth of data on new customers acquired during last year's Way Day event and we are pleased to report that the performance of these customers over the last year has been strong, giving us further conviction in our strategy for this event.

Before I turn the call over to Steve, the last thing I want to briefly touch on is our first full-service physical retail store that we plan to open in the fall this year in Natick, Massachusetts just a few miles from our headquarters in Boston. Our first entry into physical retail was with two holiday pop-up stores that we operated during late 2018 in Massachusetts and New Jersey, and our ongoing retail store outlet located near one of our CastleGate warehouses in Kentucky. You'll see us continue to experiment with additional pop-up stores in 2019 and various offerings from the Natick store as we continue to iterate and how best to reach and engage our customers.

Like all of our investments, we will only entertain expanding the full-service physical store footprint, if we believe the economic model is working and we've ironed out the inevitable operational kinks that happen when you're building something new. We view physical stores as we do our other marketing channels, meaning that the incremental contribution margin generated needs to yield a payback within a fixed timeframe, which we plan to measure and manage rigorously as we always do.

As an example, we operated our first WDN last mile delivery facility in Westborough, Massachusetts also just a few miles from our headquarters in Boston for just under a year before we felt we had to model down well enough to justify expansion to additional metropolitan areas. It is still too early to go into specifics on this first full-service pilot store in Natick. But we will provide a more detailed update at the appropriate time once our store is opened and operational.

Now, I'd like to turn the call over to Steve.

Steven K. Conine

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

Thanks, Niraj. It's been more than a year since we've updated you on our mobile app, so I'd like to briefly give you an update on the app before turning the call over to Michael.

Designing an amazing shopping experience is at the core of everything we do and creating an effortless offering across multiple interfaces is an integral part of our overall value proposition. We knew that we need to routinely inspire customers by giving them the ability to visualize our products in their homes, which ultimately leads to the confidence they need to buy for the home online.

We believe our app is an important aspect of our offering and provides an efficient channel to market to customers, which is why we are dedicating substantial engineering, product management and data science resources to enhance this capability. When we last updated you in September of 2017, the Wayfair app had been downloaded over 11 million times globally. In 2018 alone, customers downloaded the app nearly 13 million times, bringing our cumulative Wayfair app downloads as of Q1 to over 31 million.

The app continues to grow as a substantial part of our business with roughly 20% of gross revenue for Wayfair.com now coming from the app. Each year, we continue to reach new milestones of success as our app won the People's Voice vote for the Webby's Best Shopping App for the second year in a row in 2019. While we are thrilled with the quantity of downloads, we are also excited by the growth in our monthly active user base, which increased by over 80% year over year in March 2019.

Another reason that we are so excited about the growth of our app customer base is the favorable economics that we see for customers using the app. We find that our app customers are much more engaged with our site viewing far more pages in a single session than customers visiting on our mobile website and converting at a higher rate. Additionally, push notifications offer us a unique marketing vehicle as we are able to reach customers without any additional investment in marketing. Moreover, we find that customers who choose to opt in for push notifications visit the app significantly more often than those who are not subscribed to these notifications.

Mobile orders including app, mobile web and tablet account for over 50% of our total orders. From 1995, when Niraj and I first started developing software in the early days of the Internet through today, customers have changed their preferred interface to the Internet several times. Over the next several years, we expect people to continue to gravitate toward mobile devices and away from desktops and we are continuing to enhance our app experience to best serve these customers. For example, this year we will be focusing our efforts on increasing the speed of the app, while undergoing a redesign to make it feel more native.

We expect these improvements will make the customer experience more fluid, easy to navigate and fun. Another goal will be to improve our viewing room experience by leveraging our investment in 3D modeling in the AR and VR technologies that we have developed, giving customers the confidence they need to create a home they love from our family of brands.

Now, I'd like to turn the call over to Michael to discuss our Q1 financials.

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 Q1, our Direct Retail business increased 39% year over year to $1.931 billion, representing year-over-year dollar growth of approximately $540 million. Our total net revenue increased 38% year over year to $1.945 billion. In the U.S., Direct Retail net revenue increased to $1.644 billion in Q1, up 39% year over year, representing year-over-year dollar growth in the quarter of approximately $460 million.

Direct Retail net revenue from our international segment in Canada, the UK and in Germany increased to $287 million, up 42% year over year and up approximately 51% year over year on a constant currency basis. As we described on past earnings calls, our revenue from Canada is significantly larger than our revenue coming from either the UK or Germany today. After launching in early 2016, the Canadian business surpassed our internal aggressive growth expectations, reaching brand awareness and market penetration comparable to our U.S. business in just over two years as it leveraged the supplier relationships and logistics infrastructure we had built in the U.S.

Recently, our Canadian business has been facing growth headwinds with revenue growth falling below the growth rate of our U.S. business. As we talked to you last quarter, while we believe there have been some external macro headwinds over the last few quarters in Canada such as exchange rate and weaker consumer spending, we believe we can reaccelerate our growth there as we roll out our logistics operation that will allow us to reduce our cost structure and lower our pricing to Canadian customers over time.

Though Canada is weighing on our international growth and we expect that to continue near-term, our UK and German businesses where a majority of our international OpEx dollars are invested, continue to grow at a rate far in excess of our overall growth rate.

I'll turn now to our KPIs, which we report on a consolidated global basis. We were pleased to see another strong quarter for new customer acquisition with our LTM active customer base reaching 16.4 million in Q1, an increase of 39% year over year. LTM revenue per active customer was $442 and LTM orders per active customer was 1.85 in Q1, both roughly flat sequentially versus Q4. It's worth noting that both of these metrics were up sequentially for our U.S. business, but approximately flat globally driven by our international business. For example, in the U.S., Q1 LTM revenue per active customer was up 1% sequentially versus Q4.

I will share the remaining financials on a non-GAAP basis, excluding the impact of equity-based compensation and related taxes, which totaled $52 million in Q1 2019. For a reconciliation of GAAP to non-GAAP reporting, please refer to our earnings release on our IR site.

Our gross profit for the quarter, which is net of all product costs, delivery and fulfillment expenses was $471 million or 24.2% of net revenue, just above our near-term expectation for gross margins in the 23% to 24% range. As mentioned on the Q4 call, we expected to lean in on advertising in Q1, given the attractive buying opportunities we were seeing within our one year contribution margin payback threshold. The opportunities we saw and captured resulted in Q1 advertising spend of $244 million or 12.5% of net revenue, approximately 100 basis points higher than Q1 last year.

Looking at the second quarter, we expect ad spend as a percentage of net revenue to decline sequentially, but still represent an increase of roughly 75 basis points year over year. As a reminder, our general framework for determining the amount of ad dollars we can spend is based on an approximately one year contribution margin payback threshold. Some of the ad dollars we spend in a quarter generate revenue dollars within that same quarter and some of those ad dollars generate revenue in future quarters. This timing mismatch can cause ad spend as a percent of revenue and customer acquisition cost to appear inflated during periods when we are leaning in more heavily on ad spend.

We feel confident that the performance of our customer cohorts and our rigorous approach to monitoring the ROI of this ad spend justify the increased investment we've been making both in the U.S. and internationally.

Our non-GAAP selling, operations, technology and G&A expenses are driven primarily by compensation costs and in Q1 totaled $295 million. In the first quarter, we added 1,220 net new employees. We're a total of 13,344 employees as of March 31, 2019. Approximately 900 of these additions were in variable cost areas of our business, namely in our logistics operation and in customer service.

Please remember that we are adding head count in these areas not only due to the growing scale of our business, but also as we are effectively in-sourcing work that was done by third-party logistic providers in the past. Approximately 300 of those net new hires were in OpEx areas such as engineering, marketing, merchandising, product, operations including logistics leadership and technology. This level of hiring was consistent with our expectations as we outlined on our last earnings call where we expected to continue running hiring at a lower level than we did in most of 2018.

Our hiring efforts remain focused on adding strong talent to areas where we have concentrated our investments as we continue to work on strengthening our international capabilities, scaling our logistics network and further penetrating categories and services where we have historically under indexed.

In particular, our current hiring has been more focused on adding additional engineering, data science and product employees to our team, all of whom power all these facets of our business. We expect OpEx hiring for the rest of 2019 to run at approximately the same pace as it did for the last two quarters with the exception of Q3 2019 when we expect it to step up some due to our campus recruiting efforts. As a result, we do continue to expect modest year-over-year leverage in this line toward the end of this year, as we anniversary the substantial head count growth of 2018.

As expected, unutilized rent for Q1 ran between $10 million to $15 million with $2 million to $3 million of this amount being the impact of the changed lease accounting standard.

Now, turning to profitability. Adjusted EBITDA for Q1 was negative $102 million or negative 5.3% of net revenue; adjusted EBITDA for the U.S. business in Q1 was negative $28 million or negative 1.7% of net revenue; and adjusted EBITDA for the international business was negative $74 million. This was all in line with our expectations as we continue to invest across our business and as Q1 tends to be a seasonally lower EBITDA quarter for us in the U.S.

Non-GAAP free cash flow for the quarter was negative $167 million, based on net cash from operating activities of negative $81 million, which was impacted by our typical seasonal working capital movement following the holiday period and capital expenditures of $85 million or 4.4% of net revenue. For Q2, we expect CapEx of approximately 4% to 5% of net revenue. As of March 31, 2019 we had approximately $806 million of cash, cash equivalents and short and long-term investments.

With that, I'd like to turn to guidance for Q2 2019. We forecast Direct Retail net revenue of $2.2 billion to $2.25 billion, a growth rate of approximately 34% to 37% year over year and representing year-over-year Direct Retail dollar growth of approximately $550 million to $600 million. To give transparency on current trending, our Direct Retail gross revenue quarter to date has grown just about 40% year over year.

The timing differences for both Easter and Way Day in April this year compared to last April, make the comps within the month more difficult to read. Our guidance for Q2 reflects that and as always, I must make my typical refrain that in our mass market consumer business, the customer has to show up every day.

For the U.S. business, we forecast Direct Retail year-over-year growth in the range of 35% to 38% and expect international Direct Retail year-over-year growth within the range of 30% to 35%, driven by Canada as I discussed earlier. We craft our guidance for revenue growth on an as reported basis, but it's worth pointing out that on a constant currency basis, our guidance will be approximately 35% to 40% for international growth and gross sales quarter to date for international are up about 40% on a constant currency basis.

We forecast other revenue to be approximately $10 million for total net revenue of $2.21 billion to $2.26 billion for the second quarter. We are continuing to make the investments in our business in the U.S. and internationally that are resonating with customers and have been central in our success to date. As I mentioned before, we have always invested in a way that best serves our customers over the long term and we do not link our spending at any particular quarter to revenue in that quarter.

For consolidated adjusted EBITDA, we forecast margins of negative 3.3% to negative 3.6% for Q2 2019. These losses are primarily driven by our international business with negative EBITDA in the range of $75 million to $80 million expected for Q2.

We're extremely pleased with the gains our business is making in Europe and we are continuing our investment accordingly as we position ourselves for further market penetration much like we've done successfully in the U.S.

We expect international adjusted EBITDA losses to continue roughly at similar levels in the near term as we scale our investment in the UK and Germany specifically. In the U.S., we expect to deliver approximately breakeven adjusted EBITDA margins, which means it could be 25 to 30 basis points on either side of breakeven.

We continue to see the results of our investments paying off due to scale we are achieving and the response we are able to generate from our customers as they reward us with their dollars and repeat business.

The U.S. business has been adjusted EBITDA profitable for seven of the last 10 quarters. And we expect that incremental flow through from our growth will continue to improve U.S. adjusted EBITDA over time. Though as always, we won't time our investments to make that happen in any particular quarter.

For modeling purposes for Q2 2019, please assume equity-based compensation and related tax expense of approximately $54 million to $56 million, average weighted shares outstanding of 91.8 million and depreciation and amortization of approximately $44 million to $46 million.

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

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Niraj S. Shah

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

Thanks, Michael. Steve and I are incredibly excited about the business' start to 2019 and we are looking forward to building on the momentum we've gained early this year. Our ongoing investments in building our logistics infrastructure, deepening our product offering and finding new ways of engaging with our customer are the keys to building the momentum we are seeing today.

We are continuing to remain very well-positioned to take a significant share of the dollars that are coming online in the home category as our team of over 13,000 people continue to make a meaningful impact in transforming the experience of shopping for the home online.

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

....

QUESTION AND ANSWER SECTION

Operator: Thank you very much. [Operator Instructions] Your first question comes from the line of Peter Keith from Piper Jaffray. Your line is open.

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Peter Jacob Keith

Analyst, Piper Jaffray & Co.

Q

Hi, thanks. Good morning, everyone. Congrats on the nice start to the year. I did want to ask a two-part question around gross margin now that you guys have seen a pretty solid expansion two quarters in a row. So, obviously, a lot of puts and takes around gross margin, but I wonder if you could talk about the complexion of the drivers this quarter versus last quarter, and if you're beginning to see any emerging benefits from logistics or sponsored SKUs at this point.

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Niraj S. Shah

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

A

Sure. Thanks Peter. On that question, so what we've talked about for years is how the 200 to 300-basis-point spread from where we are to our long-term target was basically easily covered by three factors. One is just scale, buying power; second is logistics efficiencies as we grow and with the infrastructure we're building; and the third is as we build up the house brands with the higher-quality merchandising and the pricing power we get there.

And what we said in the past is that each one of those could close the gap. So, in aggregate, as we unearth these gains, we would keep some and we would pass some back, but closing that gap would be very easy. Since then, we've also touched on the launch of newer things like advertising and some of the other services we provide which are high gross margin offerings.

Today, though, what you're seeing is gross margins just continues to hover in the range we've talked about 23% to 24%, which is what we've said it will be for a while, but you will see like logistics, for example, is starting to show some signs of benefits. [ph] In the past (38:40) what we've always had the benefits from day one were some of the customer benefits around the fast delivery, driving up conversion, driving up lifetime value, where you start to see some of the cost benefits come in.

As we roll this forward over the next few years, I think all three of these, the house brands, the logistics and the buying power are going to start showing real performance in the number. And so, I think we're on the cusp of really some exciting trends over the next few years. And then the new bucket, the advertising and what have you, we think will also be quite exciting. Today, though, what I would say is that the advertising, that bucket's still very small, not really driving any of the number today. And what I would say is we're in the super early days on logistics, on house brands and on buying power. So, there's no single thing that's off to the races, but everything is primed for future gains. And if you go out – not a quarter or two, but you go out one, two, three years, I think you're going to see a lot of that happen.

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

A

And Peter specifically on...

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay. That's [indiscernible] (39:34)...

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

A

I was going to say, Peter, specifically on Q1, you'll see that if you look at the year-over-year compare, you'll see it shows up both on the product margin side and [ph] initial cost (39:44) side.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay. That's helpful. A real quick follow-up and one point of question we're getting from investors is on that private label side as a driver, you're already at 70% of sales, I believe. So, could you talk about where there's opportunity within that 70% as we look forward to the next two to three years as you state?

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

A

Yeah. So, I think the last stat we gave was that we were at 74%. It's not so much that the 74% becomes a 100% or anything like that. There is an upper limit it's higher than 74%, but we're getting close to it. And there're certain categories we have where they are branded categories and what we do there is we deeply partner with the brands, these are brands in things and categories like large appliances with folks like GE or with categories like grills or plumbing or small electrics, and so there's a piece of our business that is branded as well.

What I will say though is the benefits, the economic benefits in pricing and gross margin from private label is not a function of just what portion of the business is that, but it's also a derivative of the quality of merchandising support we're able to put behind those brands, those collections we create.

So, we're not doing the traditional thing of designing products and buying inventory and trying to make sourcing more lean. Instead, what we're doing is we're partnering with all our suppliers. We're curating in literally tens and hundreds and thousands of items into these brands, but then what we're doing is we're putting our energy not in the product design and manufacturing, but in the curation, in the merchandising.

So, if you have the quality of visual imagery, the portion of the catalog that has 3D models what we're able to do with full environmental imagery as we get more models, the way in which navigation on the site lets you really explore rooms and styles, that is what we have found unlocks a lot of the pricing power. And, I mean, just to point out a – if you said, well, we're 200, 300 basis points away from our target gross margin and say we want to close that whole gap with this alone, well, the average order is $250, 300 basis points is what? $7 or $8? $7 or $8 – if I told you an item is $249. I told you the item is $259, which is a $10 swing, it's 400, 500 basis points. You don't really know if an item is $249 or $259.

So, when the high-quality merchandising is there with the user generated content and users uploading photos and really good detailed information, the whole collections are very well merchandised, and you can see how items go together and all of a sudden that gross margin becomes easy to unlock. That's where the gains will come from.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay. That's very helpful feedback. Thanks a lot.

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

A

Thank you.

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

John Blackledge
Analyst, Cowen and Company

Q

Great. Thank you. Just a couple of questions on fulfillment and one on Way Day. On fulfillment, how far along is the buildout of CastleGate in the U.S.? And maybe Niraj, can you talk about the difference in the customer value prop now relative to a couple of years ago when CastleGate wasn't as scaled? And then with Amazon going to One-Day Prime just any thoughts on Wayfair essentially going to one-day delivery at some point? And is that needed in your category? And then, just on Way Day, any color on the impact or growth or growth relative to last year? Thank you.

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

A

Sure, great. On the – first question on fulfillment. So, here is the way I would describe. When we first tested fulfillment just to prove that there was a customer lift on both conversion and lifetime value, we tested it with these two warehouses in Kentucky and Utah – now it goes back four, five years ago. But the network we started building after we successfully proved that that worked was actually a network that was meant for the future and we think the future is actually next-day and same-day it's not two-day. And so, the way that you have an effective same-day and next-day network is you need a couple few things.

One is you need significant volume and the second is you need the finished goods to be stored very close to the population centers. And I guess the third thing is, you need to control your own transportation in ways that allow you to run on cycle times you want not just on – you can use overnight delivery networks, but also for things like our WDN network, you need to be able to control your cycle time and control your scheduling.

So, if you look at what we've done over the last four or five years, we've increasingly opened warehouses in coastal locations. So, the beauty of coastal locations, if you're thinking about a few million square feet in Cranbury, New Jersey – well, Cranbury, New Jersey is very close to a major port, 80% of the goods come in from Asian countries, right? So, if you think about being close to a port, you have the lowest inbound cost that you could possibly have. And then, that Cranbury, New Jersey happens to be halfway between the number one population center in the U.S., which is Metro New York and Philadelphia which is a top 10 population center.

[ph] With (44:27) 2 million square feet in Perris, California, just 70 miles from Los Angeles, second biggest center, again major port center. You start thinking about what we've also [ph] done at (44:34) Atlanta, Dallas, Toronto, and where we are located in Northern Kentucky which is outside of Cincinnati, Ohio is very densely populated area. Then you think about what we're adding, Northern California, Jacksonville, Savannah, you start basically picking very low inbound, low-cost locations, you have a low first cost, but the goods are already positioned very close to the major population.

So, all of a sudden, running a next-day operation or a same-day operation is quite easy to do if you control the logistics, you have the integrated transportation, and you can actually do it at a very low operating cost, lower in fact than if you were doing the traditional methods of transportation and keeping a smaller number of inbound locations, particularly if [ph] you had high dredge (45:10). So, the way we think about fulfillment, we now have enough of a footprint, we're not building a footprint just to build a footprint.

So, at this point, we're really building additional capacity as we need it because of demand, because what's happened is the percentage of our business that goes through CastleGate keeps expanding. But then as you know the business is obviously growing. So, when you think about the unit volume going through CastleGate is the multiplier of the two, and so that necessitates more and more warehouse space. We then use that opportunity from more warehouse space to take advantage of incremental locations that preserve that low cost advantage, but let us cover more and more population with superfast, ultrafast delivery.

My feeling about ultrafast delivery is that that's going to more become the norm than the exception in all customer categories just because the customer desire has a high emotional component along with the need component. Our category is really driven less by a need component, because the truth is if you think about everything we sell, you wouldn't need a much more modest amount of it than you buy. And the reason finding that perfect item out of a huge selection and getting it quickly is so exciting is that there is a huge amount of emotional satisfaction that comes out of that. And we certainly want to be able to provide that.

The key to what we're doing and I think the really important thing to think about like inbound logistics what we're do in Asia with consolidation, we're doing with ocean freight and dredge that end to end view, transportation is a bigger factor in our category than in almost any other category.

If you look at the cost of $1 of revenue and if you say $0.75 is the cost of goods, well the truth of that is it's something like $0.55 is the product and $0.20 is transportation and logistics. And that $0.20 is the only piece of the whole cost chain that by optimizing it, you basically improve the customer satisfaction because of the speed of delivery, the ease and the quality of delivery, but you actually reduce your cost because of the efficiency and you're able to remove damage, which is a particular and key issue in our category.

So, for us, optimizing that basically not only gets you to same-day, next-day, but frankly it actually makes your cost structure more and more advantageous. So, that's the direction we're building it on. And so, this year, we're [ph] just scaled at 17 million (47:13) square feet, basically driven off the need we see for space based on the demand we have from the suppliers, but it gives us that advantage with more and more locations for faster and faster delivery.

Your second question on Way Day, Way Day was just a huge success. It was our biggest day in our history. We continue to be really excited that that mix of repeat and new customers continues to hold. So, it's not just a great event for existing customers to come back which it is, and it's not just a great event to get new customers, which it is, but it's both. And we're not getting – we're getting high-quality customers. So, we're not getting customers who only come on [ph] mirror (47:44) promotion. And that was one of the big benefits of now having a year's worth of cohort data on the folks we got last year, they are actually just really high-quality customers. Way Day was a reason to come explore us further. And the fact that – we're effectively trying to turn it into a national holiday for home that's synonymous with Wayfair and then lot of what we saw in reaction this year I think supports that's why we're really excited about that.

John Blackledge
Analyst, Cowen and Company

Q

Great, thank you.

Operator: And your next question comes from the line of Aaron Kessler of Raymond James. Please go ahead. Your line is open.

Aaron Kessler
Analyst, Raymond James & Associates, Inc.

Q

First on retail, should we view that more for kind of brandings in select cities or potentially if these are successful, do you see these become a long-term potentially materials sales channel? And how are you going to leverage stores to maybe further improve conversion rates on things like – there's probably some conversion opportunities like swatch samples for furniture, for example? Thank you.

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

A

Yeah, absolutely. So, the way we think about stores, Aaron, is if you think about the evolution of our marketing, if you go back just a handful of years ago, everything we did for marketing was effectively online, right? And so, way back when we started with keyword search being the key mechanism, but four, five years ago, we were really more or less expansive in every online channel with kind of a huge competency in both the ad tech on how to traffic and target it, but also how to measure it in the quantitative models, and that was a huge strength of ours.

The limitation though is online there's certain types of engagement you want to have with the customer that are limiting. But then one channel we were able to figure out for example was direct mail. So, now when you have a catalog that sits on the coffee table for a few months or a postcard that's in the mail that gets right in front of that person, there's things you can do that were harder to do online, there are some advantages, some disadvantages, but it's an incremental channel that lets you do different things. And again, with that competency to measure it, you're able to then figure out how to use the combination of the two to get even more effective from a reach, from an economic performance standpoint, so on and so forth.

Well, then, the third one we added was television. 30 second television commercial in which you tell a story in a way that neither of our other channels or none of our other channels was able to do. And so, we figured out what the right use was for it. We figured out how to measure it, how to measure it as a part component of the total, so things don't get double count and double credited, and that's been a key lever for us.

Well, we think of a store as perhaps another major next leg of that stool. So, with the store, we now have the ability to have an in-person interaction that's richer than what we have today. So, today, the only in-person interaction we're able to have today other than with the technology is if someone contacts us in customer service. So, we have a large customer service and sales team, you can call them, you can do chat with them, you can email them. That can be one-to-one interaction. But again, there's a limitation on how far it can go, because it's not physically in-person, it's in-person but over a distant medium.

So, now in a store, you can engage with a person, you can provide them with advice, you could explain how the technology works to your point about swatch samples or things that you can do that are a little more immersive. You certainly wouldn't be able to showcase the breadth of the selection we have. So, we don't think of a traditional store with just racks and racks of products and at the end of the day still a very narrow limited selection is the way to go.

We think the way to go is how do you help someone continue to get fully immersed in Wayfair, help them get more and more engaged, help them solve whatever their challenges are, help them learn about us, measure it as a marketing channel where it needs to provide the same kind of cohort payback that we expect from our other channels, so we can measure it very precisely and finitely.

And we think it can be a leg of the stool in the same way that direct mail was a meaningful part of the stool and about 10% of our total ad spend, television's about 15% of our total ad spend very meaningful, while we think stores can be a component part of it, but we think it'll take some experimentation to fully figure it out.

Aaron Kessler
Analyst, Raymond James & Associates, Inc.

Q

Great. Thank you.

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

A

Thanks Aaron.

Operator: Thank you. And your next question comes from the line of Oliver Wintermantel of Evercore ISI. Your line is open.

Oliver Wintermantel
Analyst, Evercore ISI

Q

Yeah. Good morning, guys. I understand that EBITDA was in the guided range as percent of sales. But if I would have modeled revenues close to 40% and then gross margins above the range as well that you gave, I would have thought that there's more leverage on the EBITDA line. Can you maybe explain why there was not more leverage on EBITDA with such a good sales growth?

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

A

Yes, sure. Let me chime in and then Michael can add to it. So, if you think about our cost structure, right, there is three main components, so there's a gross margin to your point that actually expanded, then there's advertising and OpEX. And so, basically the way to think about it is advertising we manage that not to deliver some sort of particular targeted EBITDA, but we manage that around the concept of payback. And the payback I think is a much stronger concept because a budgeted amount could turn out to be too little or too much relative to the economic return you want, whereas when you keep the payback targets very tight and you measure them very precisely, you know you're going to get the economic return you want.

And so, one of the things that we've had a good opportunity to do is we continue to build out our own ad tech and at the brands we have to get stronger and stronger. We occasionally find pockets of advertising event that allow us to get more customers on an economic return faster, we then take advantage of those. And so, the route on advertising leverage over time is not linear. And that's one of the factors that would hit EBITDA on the near period, but be very good economically over the long-term.

And then on the OpEx side, we've talked about how we're slowing the rate of OpEx hiring, but remember the folks we added in the fourth quarter you add over the course of the fourth quarter. And then in January – in the first quarter you pay them for the full first quarter, right? So, the rate of hiring has really slowed as we've gotten into this year. But what happens as you know it takes a little while for your payroll to normalize. In Q1, you had a little more incentive, payroll, taxes and some things. Then there's some things around the red line and some accounting adjustments. So, I think that's driving a little bit of it, but Michael can probably clarify that.

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

A

Yeah. I mean, the only other thing I would add probably is, as you know, we are never trying to time what the quarter results are. So, if the marketing team sees the opportunity to spend within our payback thresholds on ad spend, we're going to spend it. And I think throughout Q1 there was sort of real good strength there and we noted that when we guided that we were sort of going to create some deleverage there and that there was – we were going to lean in and I think that felt good all the way through the quarter.

Oliver Wintermantel
Analyst, Evercore ISI

Q

All right, thanks very much, good luck.

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

A

Thanks, Oliver.

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

Brian Nagel
Analyst, Oppenheimer & Co. Inc.

Q

Hi, good morning, thanks for taking my questions. First of all, I'd like to add my congratulations for a nice start to the year. So, two questions if I could. First off, with regard to international and specifically UK and Germany, I know you discuss this a bit in your prepared remarks as well as in the past. But as we're looking at the results and clearly those markets, the operations markets are going to drag upon the total company results. But what gives you the greatest confidence or what should we watch to really understand or convince us that the performance of those markets are tracking in line with what you saw historically in the United States which is now tracking towards adjusted profitability?

Then the second question I have, I guess shorter term in nature and a follow up to a prior question. But with regard to the announcement from Amazon, how much of your product right now is being shipped either same day or next day? Thanks.

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

A

Great. Thanks, Brian. So, first on Europe. So, Europe is actually an incredible opportunity. It's the same size market as the U.S. and Canada. And as we've gotten deeper into it, I would say if anything, the opportunity there is as large, you could even argue, it might be bigger because of the historical fragmented nature of Europe and the kind of more limited selection that's available to any resident in any particular country.

The way we know it's working well is basically the same way we know the U.S. is working well so on and so forth, which is really we you look at customer conversion rate, we look at customers repeat rates, we look at effectively the loyalty measured in directional things like engagement and traffic and what have you.

And what we've been able to monitor over a multi-year period is we've seen how – when you steadily increase the experience, those things climb. There's a threshold at which you really want to see the customer conversion rate and the repeat rate at before you're really willing to lean in on marketing and then marketing you're then going to do the same way with payback periods that are very tight, so you know you're not over your skis and then you're going to look to see how those cohorts of those customers act on those metrics around repeat.

And what has happened with UK starting in 2015 which is why we kicked off the brand building then is we had hit those thresholds and what we've seen in the years since is those metric continue to rise and actually mirror the U.S. rise over a series of years just offset by a number of years, but rising at a very similar pace, and we see ourselves gaining steam and all our survey work as well in the UK market supports that, and the underlying economics keep getting stronger as that develops.

Germany is the same story, but offset by a couple of additional years. So, in Germany, we really started investing it in 2017, and the brand building efforts are even more recent than that. So, what you're really seeing is that the story is playing out, but because of those time lags because we're doing things a very methodical way to make sure that they in fact work, when you aggregate the international P&L, you see it all that initial cost you need from that team in order to really make the offering work.

You have that cost and until you get to a certain level of scale, you really can't cover off that OpEx. But what happens that exacerbates it in the second phase is that then you get to the point where you can advertise very effectively. That then creates even more significant cost, but you don't yet have the repeat base that amortizes that. So, then what happens, as you start growing, as the repeat starts taking share of the total, same thing that happened in the United States, and the U.S. we were negative 7% EBITDA in the beginning of 2014. And as you see we've now been profitable to whatever seven out of the last 10 quarters or whatever it is. And that's just a function of the leverage as we scale not a pullback or a change in strategy. Well, Europe is tracking along the same metrics, but you have to go back a number of years in time to kind of overlay the charts.

On your second question about the logistics network, so what's happening is as we get more and more goods into the CastleGate network the same and next day numbers continue to rise. So, we've never disclosed the exact percentage at same versus next versus two-day, but effectively what we're working to do is have that network be the vehicle to keep taking cost out of the logistics chain while providing faster delivery at the same time. So, those two are not incompatible. We wouldn't expect faster delivery to be the thing we focus on at a higher cost, nor would we expect the cost focus to be a thing that requires us to slow delivery. We actually think the two fit together and that's been the trend over the last few years as the network density has grown in terms of the location as well as the volume.

And so, now we're in a point where CastleGate is no longer a pilot where suppliers think about perhaps tying it out, it's become more or less a standard operating method for our suppliers for the items that have velocity. And as we unlock more and more ability for them with Asian consolidation, us taking over the inbound, this just makes it easier and easier for them to use it more and more, we're then therefore building the capacity, so that we don't have to turn them away. But basically that evolution will continue to shift not just to today but the shift actually keeps you moving two to one, same, it keeps pushing you down automatically as more and more density of volume come into the network. So, maybe at some point, we will break up those exact numbers, but we've never provided the split.

Brian Nagel
Analyst, Oppenheimer & Co. Inc.

Q

Got it. All very helpful. Thank you.

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

Great. Thanks, Brian. And, thank you everybody for joining us today. We are out of time so that will be the last question. Thanks so much.

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

Thanks.

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

Thanks, everyone.

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